

COMMERCE COMMISSION HEARING

RE: ELECTRICITY LINES REGULATION: REVIEW OF THE
INFORMATION DISCLOSURE REGIME AND IMPLEMENTING VALUATION
CHOICE FOR SYSTEM FIXED ASSETS

11 APRIL 2005

Commenced at 9.40 a.m.

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Roger Sutton, CEO
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Powerco

Steven Boulton, CEO
Tom Weston QC and/or Victoria Heine, Partner, Chen &
Palmer
Jeff Balchin, Director, The Allen Consulting Group
Matt Pritchard/Joanna Perry, Partners, KPMG

Pricewaterhouse Coopers

Lynne Taylor, Director, Corporate Finance

The Lines Company

John Anderson, CEO
Brent Norriss, Engineering Manager

Transpower NZ

Howard Cattermole, Regulatory Strategy Manager
Peter Franklin, Financial Controller
Glen Thomson, Grid Economic Manager

Unison Networks

Ken Sutherland, CEO

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Richard Sharp, Financial Controller

Anton Murashev, Regulatory Analyst

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WEL Networks

Mike Underhill, Chief Executive

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OPENING REMARKS BY CHAIR

CHAIR: Good morning everyone. I would like to welcome you to the final day of the Commerce Commission's Conference on Information Disclosure and Asset Valuation Choice. I will not repeat the introductory comments that I made at the beginning of the last session, we will go straight into the first presentation, which will be Marlborough Lines. We will be taking a break part way through Orion's presentation, so at the end of Marlborough Lines I would ask you to stay in the room for the second session.

So, it's now for me to welcome Marlborough Lines and thank you very much for taking the time to come to see us on yet another day because I know we had some trouble fitting it in last time, so we are grateful to you for that.

I would ask that you introduce yourselves for the record, of course, and then begin when you are ready, thank you.

PRESENTATION ON BEHALF OF MARLBOROUGH LINES

MR FORREST: Good morning, my name is Ken Forrest, I am the Managing Director of Marlborough Lines; and with me is the company's Deputy Chief Executive, David Waters, and both of us will be making a presentation.

CHAIR: Thank you.

MR FORREST: Do you want me to carry on?

CHAIR: Yes please.

MR FORREST: First of all, I would like to thank the Commission for your patience in relation to this. This is the third occasion that we have endeavoured to make the presentation and it would have been very easy for the Commission to say, well, time moves on and you didn't have time to hear us, so we appreciate the opportunity. Thank you.

We also appreciate and recognise the Commission's responsibilities and obligations in terms of monitoring the lines companies but irrespective, we would respectfully request that the Commission undertake a cost benefit analysis in each area where further change is proposed in relation to the regulatory regime because, as a matter of interest, over the last three years in Marlborough Lines regulatory compliance, specific in relation to the electricity industry, has cost the company in the vicinity of \$300,000 to \$350,000, and on a per consumer basis that works out at approximately \$16 per consumer, or 4% of the net amount received by the company for line charges in respect of a typical domestic consumer as defined by the Ministry of Economic Development.

We would also respectfully submit that increasingly the Commission seems to be moving towards inputs in process rather than on quantifiable outputs and when we undertake a comparative analysis of specified criteria for the disclosed information for a wide range of line companies, it seems that a snapshot in time can only be

meaningful if a whole lot of varying parameters are taken into account, and when that's done the validity of the comparisons in some instances typically collapse.

For example, Marlborough Lines is a part owner of Nelson Electricity, which is the densest network in New Zealand at 36.5 consumers per kilometres, and OtagoNet with 3.3 per kilometre. Because of our knowledge of those two networks and our own network in Marlborough, we recognise that it's inappropriate to seek to make comparisons between those networks and we would just make that point in passing.

In any event, from a consumer's perspective, it seems the items of interest relative to supply are reliability, quality, and of course price.

In each of those areas, the consumer's measurement is in real time. Consumers always have the opportunity to make direct representations to the company if the consumer is not happy, there's public pressure through the media, and also consumers have the opportunity to make a complaint to the Electricity Commissioner who of course has the capacity to address any injustices suffered by the consumer.

So, what we would like to just make the point is it's important to take into account those other mechanisms so that we don't have a whole lot of unnecessary or increasingly more complicated regulatory regimes in relation to the electricity industry because a network company is, of course, a long-term business, it has long-term assets and it requires long-term planning.

If we have intrusive and prescriptive regulation, particularly in relation to the valuation of assets and the classification of expenditure, it's inevitable that network companies will be disinclined to invest in research and development or pursue new opportunities to

the longer term detriment of the industry.

We would suggest that it's better to over invest rather than under invest in infrastructure assets and there's plenty of examples in New Zealand where there's been insufficient investment, and overseas in relation to the electricity industry as well.

So, our general position is that regulatory requirements should not inhibit sensible longer term investments nor the appropriate maintenance of the assets.

Just by way of example from an environmental perspective, in Marlborough for a long period of time, in excess of 20 years, we have had a programme to convert overhead lines to underground and because even the latest ODV requirements do not enable us to include the underground lines at full cost, our board have said that no further overhead to underground conversions will occur, and that's really not in the interests of the community overall.

I think it's fair to say the community has expressed widespread support over a long period of time for overhead to underground conversion but in commercial terms, it's not sensible to convert power lines from overhead to underground if we can't include the full cost in our asset valuation.

In any event, in the case of Marlborough Lines, the company is Trust owned and all the benefits of the company's operations are either reinvested in the company or returned directly to Marlborough's consumers. It seems incongruous to the directors and the shareholders of Marlborough Lines that tight controls are imposed on Marlborough Lines as a network company when energy suppliers continue to be unregulated.

By way of example, over a period 15 November 1999 to 15 November 2004 TrustPower and Meridian charges increased

by 64.43% and 82.2% respectively, whilst Marlborough Lines network charges have reduced by 9.24% over that period, although I acknowledge that we increased our prices last year and we have increased them or we will be increasing them this year and we've already discussed that with the Commission and I appreciate there are issues to be worked through in terms of the price path and we are continuing to do that with the Commission.

The basis of comparisons in relation to price increases I mentioned just before are detailed in the appendix of the submission and we have provided that to you this morning.

At this point I will hand over to David and ask him to continue.

MR WATERS: Thanks, Ken. So, just dealing first of all with the objectives, principles and information needs set out in the discussion paper. One of the comments we have is that the paper appears to be of the view that "information disclosure is for the benefit of a wide range of interested parties" and we just make the point that, in our experience there is very little interest from the public generally in the information disclosed. I cannot recall, and no-one round our office can recall, any one of our customers asking to see any of this information. Generally, the only people who seem interested in it are consultants or other line companies.

So, another area suggested in the discussion paper is the suggestion that we should or may be required to disclose information about the overall business of the company and we just make the point that we have investments in other networks, as Ken said, in Nelson and Otago, and those bodies will, we understand, continue to be covered by the disclosure requirements, so it does seem a little incongruous to ask that we should have to

disclose information about our investments in those businesses.

And similarly, we operate a contracting business and the only person who would benefit from disclosure of information about the contracting business would be our competitors in that business and they have no requirement to disclose information.

It just seems to us there's a general thrust throughout the paper which suggests that the - or seriously discounts the role of the auditor of the information disclosed.

We suggest it would be more appropriate for the Commission to, if it so requires, be more prescriptive and perhaps offer more guidance to the company and to the auditors as to what its requirements are and then allow the auditor to audit the accounts or the disclosed information on the basis of those guidelines and, in doing so, then not require that additional level of disclosure regarding the other businesses.

Paragraph 18 of the executive summary suggests that the Commission "tends to favour tightening their prescription of certain data items". I guess, further in that paragraph it talks about to correct for differences between businesses and we just make the point again, and I think we've made this on numerous occasions to the Commission, that there are so many fundamental differences between different line companies that it is difficult, if not impossible, to adjust to correct for all those differences.

Some networks, like Nelson Electricity, are 90% or more underground. Some networks are in relatively benign geographic areas or geographic and environmental type areas. Some have one or two large consumers. For example, OtagoNet has one consumer who is more than or

close to 50% of its total consumption.

Others have extensive subtransmission systems and a few points of supply, or in our case one point of supply from Transpower. Other companies have multiple points of supply and a much less extensive subtransmission system.

So, attempting to capture all those differences and somehow get information which would enable the businesses to be compared as if they were like with like, we suggest is impractical and probably impossible.

We believe that further levels of prescription and information disclosure based on the assumption that companies are comparable will be inconsistent with the Commission's stated principle of minimising compliance costs. We don't believe it's cost efficient, sensible, or indeed possible, to disclose information to the extent that would be necessary to allow these differences to be accounted for.

If I can now move on to financial statements and the relationship between the disclosed financial statements and GAAP. I presume I can use GAAP as a description for the general accounting principles.

We have a concern that introduction of information disclosure accounts which are not compliant with GAAP will, once again, just lead to an increased level of compliance cost and, once again, if we come back to the question of the auditor and the role of the auditor, if the auditor - if the Commission can be satisfied that the auditor has properly complied with the Commission's guidelines, we suggest it shouldn't be necessary to have non-GAAP compliant information disclosure.

We have also been down the road of having a tagged audit certificate or qualified audit report in our disclosure accounts when we were required to disclose our investment in OtagoNet at 100% of that investment because

we owned 51% and that made our disclosure accounts non-compliant with gap because obviously GAAP would want us to reflect the 51%. Now, we recognise that that isn't a requirement at the moment but it was a requirement under previous legislation.

And that just led to increased audit costs that could have been avoided if we hadn't had to meet that requirement.

One other area where we have some concerns, and we suggest has an immaterial outcome, is the suggestion in the paper that non-system fixed assets should be valued under some prescribed method. GAAP sets out a methodology for valuing those assets and we suggest that if the Commission were to introduce some different method of valuing those assets, then it's another area where the accounts would be non-compliant with GAAP and we suggest that any change in the valuation of those non-system assets would be immaterial in the overall context of the total valuation.

Another point regarding financial accounts is the suggestion of a requirement to provide projected financial information. I don't know whether Ken mentioned but we were part of the PWC group and I think PWC covered this aspect but we would just like to reiterate or reinforce that view.

We, sort of, feel almost as if the discussion paper is getting to the point where it is suggesting the Commission will require sufficient information to allow it to investigate a breach of the price path without further reference to the company that's breached and we suggest that is not really the purpose of the information disclosure but - I'll leave it at that.

One other area -

CHAIR: I just want to clarify that point, we wouldn't see it

that way, that we wouldn't have to have discussions with the company, whatever the disclosure regime might be, I just don't think that's one of the possibilities.

MR WATERS: No, well, I guess my point is that it seems that the level of information which the Commission is suggesting may be required is almost to that level and we just wonder whether that's really necessary.

Carrying on. There's a suggestion in the paper that assets included in the Statement of Financial Position may correspond to the regulatory asset base the Commission would use in an assessment, and we just make the point we don't believe that's correct. The asset valuations in the information disclosure are based on ODV and the rules for ODV may be quite different to the rules which a company would use in valuing its assets on a DRC basis, and we have, in our submission on the price path or threshold breach, made some adjustments to our ODV value because we believe that the Commission's or the ODV handbook is over prescriptive in one or two areas.

And also if we were required to reflect in the information disclosure financial statements the ODV value, then that's just another move away from GAAP and we submit that that difference should be adjusted for in the derivation table and not in the financial statements of the information disclosure.

Work under construction, we did a little bit of - just summed up the 2004 information disclosure for all ELBs excluding Transpower, average work under construction totalled \$4.3 million or 2.1% of total ODV values. We suggest that if that is a typical level of work under construction, or typical for any one company in any one year, then introducing further highly prescriptive rules regarding interest on construction costs etc. is just adding a degree of complexity that just isn't warranted

for the relatively immaterial amount of money involved.

However, we do accept that Transpower may well have quite significant work under construction at any given time. So, we suggest that the Commission set a materiality threshold and that companies who have work under construction of less than that threshold should then just be able to treat work under construction as an asset.

One of the suggestions in the paper refers to a comment by Meyrick suggesting that further information on labour usage, quality and cost of own labour, purchase of materials etc. should be disclosed. Where external contractors provide these services, that information is unlikely to be available and, in any event, even for self-constructed assets, attempting to compare construction costs between central Wellington and D'Urville Island in the Marlborough Sounds is fraught with all forms of difficulty and we do not believe that it would be practical for the Commission to draw some conclusions from comparing those types of construction or construction in those sort of areas.

Any attempt to benchmark lines business performance where these differences occur would almost certainly end up with erroneous outcomes and costs of compliance, again, must raise its head.

The paper talks about, in paragraphs 212-215, statement of cashflows and then goes on to suggest a comparison between asset management plan, CAPEX and actual CAPEX, but that just totally appears to ignore accrual accounting. I mean, statement of cashflows is a totally different thing to financial accounts and we suggest that to compare accrual accounting projections in an asset management plan with cash accounting actuals is pretty nonsensical.

If there were to be a need to be some form of

comparison, then it should be on an accrual basis and if the Commission considers it's necessary, included in a separate section of the information disclosure.

ACAM, avoided cost allocation methodology, we do support the retention of that and agree that there is a need for further prescription in that regard but we do make the point that that prescription should then be audited by the auditor, or that prescribed method should be audited by the auditor of the information disclosure, and that there shouldn't be any need for additional disclosure to show that companies have complied with the Commission's requirement.

Obviously following a threshold breach, the Commission could ask for more information and may perhaps over time then gain some comfort or possibly the alternative, as to whether the auditors are meeting that function but in the first place, we suggest that further prescription and auditor sign off should be sufficient.

We are also concerned at the suggestion that companies with non-contiguous networks may be required to disclose information on a separate basis. One of the advantages, perhaps, of mergers/acquisitions, is reduction in overall compliance costs, including compliance with the Commission's regime, and those synergy gains should not be eroded, or partly eroded, by the need to provide information to the Commission on separate parts of - or on non-contiguous networks.

We suggest that any exercise to require that type of disclosure would just introduce a further range of costs allocation questions or issues requiring further prescription and in all probability introduce further anomalies. So, we just have some difficulty with that concept.

We do agree that in the year of acquisition there

should be some special disclosures but we do urge the Commission to consider the time series disclosure. Marlborough Lines in the year that it acquired OtagoNet had some significant difficulties in (a) understanding and (b) complying with the immediate requirements in this regard, particularly with things like obtaining information on the acquired network in that period covered by the disclosure and also some of the technical things, or efficiency I think they're called, load factor reliability data, become a little nonsensical if you're talking about six or nine months worth of data.

So, we just urge caution in devising rules for any sort of time series disclosure.

Distributor generation, we applaud the Commission's preference for a "simple treatment" and we suggest that there should be some form of commonsense materiality limit. Distributor generation is in its infancy and it would be disappointing if we had to disclose or spend a lot of time disclosing information for two or three kilowatts of generation, so we think there should be some sensible materiality level.

Similarly, in terms of load management, we believe there needs to be some form of materiality taken into account. We understand most ELBs have retained the central signalling system and some have sold the receivers, some have retained them.

Investment in the signal generator equipment is generally of a step nature, as old equipment is replaced or new equipment commissioned, but the operating cost of that equipment is generally immaterial in terms of the total cost of operating for typical ELB.

Performance measures and statistics. There is a problem with direct and indirect costs. Obviously, different people interpret them quite differently and

further prescription would be appropriate but there is a danger in attempting to over simplify the information disclosure in this regard. The different denominators, line length and consumers, were originally introduced in recognition of differing consumer density across different ELBs.

The number of ICPs does not necessarily impact on direct systems operating costs.

If a single common denominator is being sought, then we would prefer to use system length. However, we do believe that there are costs which properly should be allocated on an ICP basis.

Another area where we have some problems, and we have in various other conferences mentioned this distribution transformer capacity utilisation and the use of that in comparing networks. Once again, comparing a network like Nelson Electricity, which is predominantly central city area, with an area like Marlborough Lines with its Marlborough Sounds area and significant irrigation load, and again with OtagoNet with its one very large customer, you will get quite different answers which would, just looking at numbers, tend to suggest that that company is very efficient in that regard and that one is not at all efficient in this regard.

So, you do need to be careful about comparing numbers when you are comparing companies which are so widely diverse and isn't in both geographic and consumer size characteristics.

There is a suggestion in the paper that there may be changes to the quality requirements and we just make the plea that any changes in this area be signalled well in advance. The paper suggests, I think, in late 2005 there may be some information or some more details of what might be required in the future. We just make the plea that we

be given sufficient time, if the rules are going to change significantly then we may need to install further monitoring equipment, we may need to change quite a number of things within our system, not in terms of electricity flow but just monitoring equipment to enable us to monitor and get the information to comply with the Commission's requirements.

It may well be if we receive some information in late 2005 and if those requirements were to apply for the 2006/2007 financial year, we need to have that equipment installed by 1 April 2006 and it may be that it's just not practical to do so. So, we just urge the Commission to be aware of that aspect in setting the rules.

There is suggestion within the paper, or questions within the discussion paper, regarding the Commission's requirements and the requirements of other government entities, such as the Ministry of Economic Development and the Electricity Commission.

We made the point within our submission that Marlborough Lines, well all lines companies, had been inundated with rule changes and requests for submissions on all sorts of issues arising out of the Electricity Commission in particular. Most, I believe, medium sized or small ELBs just do not have the resources to enter into that process, so there may well be areas where the Electricity Commission, in particular, is considering some form of information disclosure that we're not familiar with. So, we just make the point that we think it's essential that the staff of the Commission and the Electricity Commission liaise to ensure that we don't get placed in a position of compiling different sets of information which basically say the same thing but are required to be submitted in a different form.

Finally, in this section, dynamic efficiency is

discussed in section 325-328 and there's a suggestion that the appropriateness of investment can be decided in relation to the rate of growth in demand on the network. We just make the point that if we are measuring system maximum demand, that would totally ignore capital expenditure required to supply summer only load, such as irrigation, and Marlborough is at the moment in the middle of a huge expansion of the network for irrigation loads, primarily large irrigation schemes. Those schemes will have no effect on the company's system maximum demand but they are required - well, the capital expenditure is required to provide supply to those schemes.

So, just once again, I urge caution in having some rule which looks at system maximum demand and says, well, you can't justify that capital expenditure on the basis of no growth in system maximum demand.

That's all on the information disclosure. Shall I carry on with the valuation choice?

CHAIR: I would just like you to summarise that fairly quickly so we have time for questions please.

MR WATERS: Okay. We just make the point that ELBs with higher prices and higher returns at the start of the regime are advantaged relative to those ELBs with low prices and low returns at the start of the regime.

We have faced an investigation and part of that investigation has forced us, or led us, to focus on revaluations. We would just like to make the point that indexing of revaluations in any form, whether it be under DHC or ODV, we really are concerned that we are going to be forced into the situation of earning lower returns in the short-term, with the prospect of higher returns available at some point in the future.

However, the future is uncertain. Political risk, regulatory intervention, mismatch between asset inflation

and current inflation, cost inflation. So, we just submit that if revaluations are to be required to be included, some form of "probability weighting" should be applied to the revaluation adjustment.

I will just skim over the rest of it but we are concerned with this suggestion that once and for all time choice of valuation methodology. It will be a very important decision for an ELB to make if there is to be a choice between the two valuation methodologies. It will probably be one of the most important decisions that company has to make in its lifetime and we are concerned that allowing - well, the handbook suggests that we will have some information in this regard by the end of October 2005. That leaves us maybe five months to make that very important decision, and it is important to recognise that small/medium sized ELBs do have limited resources to properly consider these comparisons and make that decision.

And that's about that. Thank you. The end.

CHAIR: Thank you for that summary. Commissioner Bates will start the questions and I might just note that Paul Sell, the Commission's expert, is actually listening in via this audio conferencing facility, so at some point we may invite him to also ask questions.

MR WATERS: Thank you.

MS BATES: I just wanted to go over some of the statutory framework with you about the disclosure regime because I want to ensure that you understand that we have certain statutory obligations to fulfil under that regime and it seemed to me, listening to you, that you actually did have some problems with the regime that we actually have obligations to follow. I know it's boring listening to legal argument but I will try and just put the gist of it to you.

You said that, as far as you were aware, very few consumers were actually looking to you for this information, though are you going as far as saying that they didn't look at the Pricewaterhouse figures that were put out on an annual basis?

MR FORREST: I guess what we are saying is we appreciate and recognise that the Commission has responsibility under legislation, just as we have, but we are just saying from a practical perspective, and from our knowledge of the situation, consumers do not take a great interest in all of these statistics.

The thing of most consequence to the consumers is the reliability of supply at any point in time and the prices which prevail at that time.

MS BATES: Be that as it may, if you go back to the purpose statement under this sub part, it talks about ensuring reliable and timely information about the businesses and refers to such factors as profits, costs, asset values, price and quality. So, it goes beyond price and quality.

MR FORREST: Yes.

MS BATES: And it's making sure that these are available to - this information is available to a wide range of people. Do you see anybody else being interested apart from consumers?

MR FORREST: I mean, as we said before, I mean, there's the government entities, there's consultants in other network companies.

We recognise there has to be a certain amount of information disclosed and that information is information disclosed already.

But I guess what we're really saying is if the disclosure information becomes more and more prescriptive, there is more cost associated with that and what we are saying is it's really important to consider the cost

benefit of the additional disclosure information because, from our knowledge of different networks, practical knowledge within the networks, it's not easy to make comparisons.

MS BATES: Yes well, on that particular question of comparisons, it's quite clear under the regime, and I will refer to section 57V, that the Commerce Commission has an obligation to analyse the information and to publish a summary and analysis.

MR FORREST: Sure.

MS BATES: And it says so, that it's promoting a greater understanding of the relative performance, so it's clear the statutory objective is to have some sort of comparative basis available; would you agree?

MR FORREST: I appreciate that that is the case. I am not saying I necessarily agree with the statutory requirement and I know that's not the role of the Commission to address. My personal view is I think in due course the government will have to go back and readdress that and ask whether it's an appropriate thing to do.

MS BATES: But -

MR FORREST: But I appreciate your position, yes, absolutely.

MS BATES: We have the obligation to do it.

MR FORREST: Yes.

MS BATES: And furthermore, we have an obligation under section 57U, well, we have the power to fulfil our obligation to monitor.

MR FORREST: Certainly.

MS BATES: We have a monitoring role to ensure that the information is correct.

MR FORREST: Yes.

MS BATES: And we have the ability under that section, in our view, to require information which goes beyond the publicly disclosed information.

MR FORREST: Yes.

MS BATES: For verification purposes, what I think I heard you saying was when you were talking about issues such as reconciling the financial and statutory accounts, and reconciling the costs allegation under regulated and non-regulated businesses, that all we should do is just accept an Auditor's Certificate?

MR WATERS: Under some form of further prescription from the Commission as to the rules to apply in allocating costs.

MS BATES: One of my colleagues is probably better placed to follow this question up but I will put it to you, the information that you're going to give to an auditor, an auditor who makes costs allocation decisions and the reconciliation, is the sort of information that we would be interested in looking at as well under the monitoring role.

So, I can't really see that there's a doubling up of or huge costs involved in providing it to us as well as to the auditor.

MR WATERS: If the auditor had some question about - and I guess it depends on the level of prescription that's ultimately derived, but if the auditor had some question about a particular aspect, then a discussion between the auditor and management would resolve that question.

MS BATES: I suppose, let me put it to you this way, is your concern on that particular aspect, I will call it reconciliation information, and I think you both understand what I mean by that.

MR FORREST: Yes.

MR WATERS: Yes.

MS BATES: Are you concerned that it will cause you costs to provide it to us, or are you concerned that you shouldn't have to provide it to us for some, sort of, confidential type reasoning?

MR WATERS: If we were talking about the monopoly business only, then no, we don't have a problem in providing the information to the Commission and there is probably minimal cost in providing slightly more information to allow the Commission to be satisfied.

But if we were talking about the non-monopoly businesses as well as the monopoly business, or that reconciliation between the published financials and the information disclosed, then we do start to have some questions about the confidentiality of particularly the contracting business.

MS BATES: If confidentiality wasn't an issue, would your concerns be allayed?

MR WATERS: I guess it depends on the level of prescription and the level of information that is required to be disclosed because I think that if we consider the role of the auditor in the information disclosure as it is at the moment, they are purely concerned to ensure that the avoided costs allocation methodology has been complied with and they can then put those parts, those non-monopoly parts of the business over there and concentrate on auditing this section.

MS BATES: Really what I'm trying to get to is what exactly your objection is because we've got this monitoring role to carry out. In order to carry it out properly, of course we have to have access to some of the information about non-regulated businesses and I am just trying to isolate what part it is that you're concerned about. Is it the cost or is it confidentiality?

MR WATERS: I think it's both, with respect to the contracting business and it's cost with respect to any other businesses, such as the investments.

MS BATES: But do you not accept that you'd have to give the very same information to the auditors to enable them to

make an assessment?

MR WATERS: I do not believe that we would give the same level of information to the auditors on the non-monopoly businesses. The auditors would be, in my view, their role would be in ensuring that the ACAM had been complied with in terms of the monopoly business.

Sorry, we're talking about the information disclosure auditors, not the financial statement auditors, I presume?

MS BATES: I am talking about both aspects of costs allocation over the regulated and non-regulated business and reconciliation of the statutory and regulator accounts. Those are the two areas we're interested in. It is just a question of how much information you'd need to provide to the auditors anyway to do that exercise and would there really be a doubling up in providing it to us.

MR WATERS: I think, once again, it comes down to the level of prescription that the Commission has. As I say, questions or discussions between auditor and management will generally resolve any questions or - well, would be expected to resolve questions or changes to the accounts.

But if that level of prescription or level of disclosure to make such discussions unnecessary, I suggest we're getting much deeper into the financial accounts.

MS BATES: I will leave it there but it comes back to the fact that the Commission does have a monitoring role that it has to fulfil?

MR WATERS: In respect of non-monopoly businesses?

MS BATES: Well, yes. The non-monopoly thing comes into it, it is the reconciliation of information, where you get the crossover. We have an obligation to monitor that that is correctly done.

MR WATERS: Yep, okay, all right.

MS BATES: So, I mean, I think I will probably leave it there because we all understand the issue but all I wanted to do

first off was just make sure you understood that we have certain obligations under this legislation.

MR FORREST: We certainly acknowledge that.

CHAIR: We just have some follow-up questions from Commissioner Taylor, please.

MR TAYLOR: I want to follow through just to make sure I understand a question of relative detail.

Your comment about accrual accounting in the cashflows, is the issue that the information that's required is not best allied or - is best not to come through the cashflow statement because the cashflow statement is fixed asset actually spent, as opposed to the note that supports the financial accounts is adjusted by opening and closing accruals; is that the point?

MR WATERS: That is the point, yes. We're not saying there shouldn't be some reconciliation between -

MR TAYLOR: It is merely the position between -

MR WATERS: The cashflow statement isn't the place to do it.

MR TAYLOR: Okay, I thought that was probably where you're coming from. Thank you, that's all.

CHAIR: I will see if Commissioner Hemmingway has any questions.

MR HEMMINGWAY: No.

CHAIR: What I would like to do is give Paul Sell the chance to ask a few questions. Paul, I don't know if you can hear me?

MR SELL: Yes, I can.

CHAIR: If you have any questions I will take them now please.

MR SELL: Good morning everybody.

Mr Forrest, I just have one question, and that's in relation to valuation choice, it's not something you covered in a lot of detail in your submission just now. You would be aware that a lot of the other submissions that have been provided to the Commission are questioning

the wisdom of allowing valuation choice and suggesting their preferred method if there was not to be valuation choice, and I think we would welcome your views on that, and if it's not something that you have thought about, and we recognise that it's a big issue, so if it's not something you have thought about a lot to date, could we ask for that in cross-submissions, but if you have some comments on that now that would be appreciated too.

MR FORREST: Thank you. We are, of course, party to the Networks Association submission and also the Pricewaterhouse submission that's already been made.

In relation to ODV and DHC, we recognise that there should be some standardisation but at this point it's not really possible to make an informed decision in relation to the DHC valuation criteria because the details of that are yet to be enunciated by the Commission but I, of course, recognise that before the Commission can do that a lot of work would have to go into it.

MR SELL: So, do I take it that you're proposing that the Commission should continue down that path of offering the choice and developing the handbooks and so on, so that businesses can make the choice?

MR FORREST: Well, at this point I am not in a position to make an informed decision as to whether the DHC is better than ODV in relation to the Commission's proposals because we've yet to see the Commission's proposals and I am aware also that Transpower have advocated one form of valuation DHC, as opposed to ODV.

When I was here a few weeks ago with PricewaterhouseCoopers when that submission was made, I said that it was important to make sure that we had commonality between network companies when the assets were similar. For example, in relation to Transpower, a number of assets that Transpower has will be identical to those

that are within the network companies and it would seem incongruous that different methods of valuation applying to those two entities with the same assets.

MR WATERS: If I could just add something to that, just a factual thing.

In the August 2004 in the ODV handbook there is single circuit mink conductor, which is a medium conductor. Transpower has a standard value of \$36,640 and ELB has a standard value of \$28,000. Now, it is totally unbelievable that Transpower, the cost just because it's a Transpower line that it should cost close to 25% more than if an ELB built it and I just wonder how anomalies like that can find their way into the handbook at the moment, but perhaps they're what Ken is referring to, if we have different valuation methodologies then we do risk valuations of different companies drifting further and further apart and perhaps that is a potential problem for future regulators.

MR SELL: Yes. I think what we would really appreciate is some more feedback on, and maybe this will come through the cross-submission, whether you believe the Commission should continue down the path of offering choice. We would like to think that that decision could be made on the principles and without people needing to see necessarily a handbook that actually sets out particular costs for particular items, so that, if you like, a business can choose whichever is more favourable to it.

So, I think you would appreciate that there are two ways that this could potentially go now and a number of submissions have suggested that the whole philosophy of choice could be cut off now and the Commission could focus on completing the implementation of information disclosure according to one particular valuation methodology, then that obviously is a change to what the Commission had been

proposing in the discussion paper, which is that it would continue to offer choice and therefore fully develop handbooks and so on for both methodologies, which obviously has a certain cost to it and so on.

So, that's really the decision that I think the Commission would appreciate feedback to inform it on in cross-submissions.

MR FORREST: Okay, well we'll do that.

MR WATERS: Yes, we will do that and perhaps I will just make the point that if we are to sensibly compare the two options and decide whether one is better than the other at this stage, then we would need some comfort from the Commission that ODV rules or standard values would be adjusted annually.

If we are going to say ODV is fine, then we would need that assurance that ODV standard values were going to be adjusted annually, otherwise we will be back in the situation in 10 years time that we were in 2003/2004.

So -

MR SELL: I think if you have caveats around your suggestion, we would be very happy to hear those.

MR WATERS: Yep, okay.

MR FORREST: Okay.

MR SELL: Thanks for that. That's the only question that I have.

CHAIR: Thank you, Paul. We have a follow-up question from Commissioner Taylor.

MR TAYLOR: On valuation choice and your comment about probability weighting where there was a revaluation component of revenue; what did you actually mean by that? Thinking it through, I can't quite get my mind round it.

MR WATERS: Well, I guess it's difficult to suggest a number but basically what I was suggesting is that if the revaluation in intervening years of between actual ODV

calculations, if that were to be, say, CPI, that for the purposes of the intervening years disclosures, that perhaps it should be a factor of CPI, 0.7, 0.8, or something like that, to introduce the concept that the revaluation disclosed in that year may not actually eventuate in future years cashflows.

I mean, we accept that over the life of the asset, including the revaluation, is fine. It's just that the rules keep changing midstream and we are always trying to catch up and we never quite get there.

MR TAYLOR: I understand that. It was the words "probability weighting" that just threw me. Thank you.

CHAIR: I will just see if Commission staff have any questions?
(Commission staff indicate they have no questions).

I just have one question that I would like to ask, and that is with respect to the networks that you've invested in, Nelson Electricity and OtagoNet?

MR FORREST: Yes.

CHAIR: I would just like to get a good handle on how much control you have over pricing in those networks. Do you wholly own the Nelson network?

MR FORREST: We own 50/50 in conjunction with Network Tasman, the control is equal. In relation to OtagoNet, we own 51% and the Southland consortium own the balance, 24.5 is owned by Electricity Invercargill and the other 24.5% is owned by the power company. Control in relation to that company is equal.

CHAIR: So, how do you set prices in those networks? Is it in line with the broad approach of price setting in the Marlborough Lines network?

MR FORREST: The prices for both of those networks are determined by their respective boards who make decisions relative to the costs that are incurred in relation to those particular networks.

CHAIR: And in terms of the required return, as shareholder what influence do you have there?

MR FORREST: Well, we are equal on the Board and in terms of Otago, the return is a very low return. The prices down there have been fixed for a period of - well, it will be three years coming up in July and that was a condition of sale when the network was purchased that the prices would be held for three years unless there were changes to Transpower's prices or changes required by government legislation. But that's something that is currently being addressed by the Board of OtagoNet, and similarly in relation to Nelson Electricity the Board of Nelson Electricity determines its prices.

As investors, we would seek to achieve an appropriate return relative to the risk and investment within the network but if we look at both Nelson and Otago, the returns are not really high at the moment.

CHAIR: But you must appoint half of the directors on the Nelson Board?

MR FORREST: Yes, we do.

CHAIR: I am following this up because of your point you have raised about the non-tenuous networks and not wanting to separately disclose for them. I have put it to others that this issue has become a live issue because we are aware of some cases where there's vastly different charges in rates of return across these networks where they have been recently required.

It does seem to me that consumers in those areas may be very interested to know about that and it seems to be a legitimate issue for the Commission to be possibly concerned with.

I would just like to get your view on that.

MR FORREST: In relation to the two networks that we own, of course we don't own the other two in their entirety, nor

do we have control, so the circumstances are a bit different.

But I think within the New Zealand network industry there will be rationalisation and it's important to recognise that the current number of line companies we have is really only an accident of history and if we are to go forward ultimately, you know, there should be more integration and I think it's fair to say that there will always be variations in expenditure within networks and I can say in relation to Otago there's been quite a lot of expenditure necessary there.

Within any individual network, there's also variation in terms of expenditure etc. at any time.

If we take another example, I know it's not in the electricity industry, but Telecom don't have separate disclosure for different plans on the network and I think the key thing is prices and if pricing in an area is out of line, then the Commission can look at that further.

But in respect of all of the other information, I am not sure whether it's appropriate to continue that in the future where you've got one set of shareholders owning it.

MR HEMMINGWAY: I have one quick question. I want to go back, I'm sorry it's not on valuation, it's on the disclosure.

You mention in your testimony that the regulatory regime has resulted in Marlborough doing less undergrounding than it had previously.

MR FORREST: Yes.

MR HEMMINGWAY: What kind of mechanism might you invent by which customers could choose whether they wanted to spend money on undergrounding or not? I can understand if a community trust is responsible to a particular community but what about the situation where the ownership of the lines is not related to the particular community, how would they express an interest in whether they wanted to

pay for undergrounding or not?

MR FORREST: Well, that is a matter between the network company and the consumers and I can say in relation to Nelson, there was an incidence where a particular street's consumers wanted supply underground and there was an approach made to the network company and an arrangement was made in terms of the costing of that and the consumers made a contribution.

But in the case of Marlborough, for example, it's been an ongoing programme, a period in excess of 20 years, with the Marlborough District Council making a contribution and the network company and its predecessors made a contribution, and the directors have determined that we shall not undertake any further overhead or underground conversion because we can't include the full cost of that work in our asset valuation and that seems incongruous because I know, and appreciate, that the ODV values have been adjusted but they still don't reflect the actual cost of installation.

In the communities, well I can say in the Marlborough community that there is some enthusiasm for extending the overhead to underground conversion further because it makes quite a difference.

CHAIR: Okay. I think that completes the questions from the Commission and I would just like to give you an opportunity for any final remarks if you have them.

MR FORREST: I would just like to say in conclusion, thank you to the Commission for hearing us, we appreciate the opportunity to appear before you and we are party to the Networks Association submission and Pricewaterhouse's submission and, again, thank you for the time accorded to us this morning.

CHAIR: I would like to thank you both for appearing and we are appreciative of the fact that I know you've made -

attempted to make three trips to Wellington, so thank you very much for that. We are always pleased to receive the Networks Association submission and the PWC submission. We are grateful that the companies are working together on that but we are also pleased to have you come before us and answer questions directly about Marlborough Lines. So, thank you once again.

I propose now to break until 11.05 when we will resume with Orion.

Conference adjourned from 10.50 a.m. until 11.05 a.m.

CHAIR: I would like to resume this session. It is now time to welcome Orion to these proceedings. I am very grateful to you for reorganising yourselves to be here today and I know you've had to bring people from far away places, so we are very grateful that we have been able to arrange this on a face-to-face meeting, so thank you very much for that.

We would like you to introduce yourselves for the record please and you can begin with a brief summary of your submissions when you are ready.

I will just note Commissioner Hemmingway needs to go at 12.20, so about 12.10, wherever we are at in the proceedings, I am going to give him an opportunity to ask any questions he might have. So, please begin when you are ready

PRESENTATION ON BEHALF OF ORION NZ

MR SUTTON: Thank you for the opportunity to appear this morning on this cloudless, fogless day. I am Roger Sutton, Chief Executive of Orion. With me, starting off on your left and my right is counsel Dr Mark Berry; I think you also all know Greg Houston from NERA Sydney; Neville Ross is our Contracts and Pricing Manager for Orion; and then Graeme Wilson is our Management Accountant here as well.

So, we were going to - the order we are going to do things was we were going to start off talking about the valuation; and then from there move on to the information disclosure regime; and then talking about the information disclosure we were going to have leading off with Greg, he has submitted a paper which I'm sure you've all seen; then Neville Ross will talk about some of the more practical aspects of the valuation; and then when we move on to information disclosure Mark is going to start off talking about the legal aspects, some of those sort of issues; and then Greg will speak; and then Neville; and then we've also been observing there have been a number of questions that have come up quite consistently over the last few weeks, so we've prepared some answers to those eight questions as we've identified them, so we can perhaps pre-empt your questions; and then I will sum up at the end.

Over to you Greg.

MR HOUSTON: Thank you and good morning. I am going to talk, I think quite briefly, about asset valuation issues in the first instance.

First of all, there's a paper we have submitted and I intend to summarise the main points arising from that paper and touch on some of the related issues arising in

the Commission's paper on asset valuation choice.

The first slide is to introduce this and provide an overview of the sort of important bottom line conclusions of the work that we've done on the topic of asset valuation.

First of all, when the paper from the Commission came out just before Christmas, Orion asked us to provide advice on two aspects of that paper in particular.

First of all, we were asked to think about the merits of offering a choice of asset valuation methodologies in the context of the threshold and control and disclosure regimes; and secondly, the form of indexation that might be appropriate for annual updates to either or both of those valuation methods.

The Commission has proposed choice of asset valuation methodologies on the basis that this meets its principles and I've summarised them just briefly on this slide. Arguably the most important one is efficiency, which is the theme or a common reference point in both of the purpose statements under sub-Part 1 and sub-Part 2, and then there are some more specific principles. The second one, and this is arguably secondly important in terms of order, a close second, is the whole question of profit measurement, which is what asset valuation goes to.

We'd see that as fundamental both to 57E, the excessive profits component of that in particular; and also 57T, the purpose statement for the disclosure regime which references both profit measurement and asset valuation.

There are three remaining principles which could perhaps be described as being more of an operational nature, which is how to make this whole disclosure regime work in an efficient way and the cost effectiveness of the arrangements, their consistency and accuracy of the

information that's provided.

I said I would give you at this stage our, sort of, important conclusion arising from this work, or the most important conclusion, and that in essence is that we think all of these principles would be better served by mandating just one valuation method for the distribution businesses, rather than continuing with having a choice.

Of the two methods that have been decided, I think that the ODV approach has some advantages.

Why is it that ODV has advantages? It is the most appropriate technique for lines businesses? Sitting at the heart of asset valuation is the question of profit measurement and the excessive profits reference point to the purpose statement at 57E, the purpose statement for the threshold and control regime. That's the area where the asset valuation methodology has the most work to do and it's also consistent with needing to understand the efficiency of markets goals which are in both of the purpose statements.

ODV in that context, or in any context but it's important in this context, is that it reflects the cost of an average efficient new entrant into this or any other business. And so, the prices that are consistent with an ODV, asset valuation methodology, are prices that would be consistent with workable competition. And so, as a general principle could not be said to be excessive. That in essence, in economic terms, is why we believe ODV is the superior methodology in this context.

It also meets, I believe, the Commission's other criteria. We've talked about efficiency but in more specific terms it's consistent with allocative efficiency, in that prices based on ODV reflect the average incremental cost of a new entrant and has some dynamic efficiency properties through its optimisation component.

I have said it already, it's the appropriate, therefore, methodology for measuring excess returns.

And I think, finally, not unimportantly, in terms of its cost effectiveness and consistency and accuracy, it is well established and understood, that's not to say there mightn't be refinements that could improve it, but there are considerable advantages in working with an asset valuation framework that's already been in place and operational for more than a decade.

Of course there are some qualifications in the merits of this methodology which really mean that it must be done - it must be implemented properly and comprehensively if it is to meet or be consistent with those principles.

I have mentioned a couple of things here which probably fall into the area of scope for further refinement in the handbook and perhaps, more particularly, the process for applying and updating the handbook as it stands at the moment for the ODV methodology.

It reflects the cost incurred about an average efficient business. It is not some best of the best threshold that's only a theoretical possibility. It has to reflect a valuation that is implementable. We have already presented on that before to the Commission.

There's also some practical matters which still remain to be resolved, in my view. When the ODV handbook was first established, it went for very many years without any updates to the unit costs which exist within it.

And of course those unit costs must be up-to-date if the method is going to have valid application in this context.

The paper on valuation choice addresses methods for indexing the unit cost but it does seem to be silent on the question of periodic updates to the unit costs which is really to address the point of whether or not the index

that you've applied is reflecting the realities of these assets which are quite specific to this sector. It seems unlikely that an index would be found that could reflect accurately the changes in the unit costs over time and so there is a need to address the question of some sort of periodic process for updating the handbook, which I acknowledge has just taken place but it would be unfortunate just to let that drift on without perhaps making some commitment or signal to when and how often that process might be undertaken going forward.

Secondly, the unit costs exercise or the unit costs in the handbook are maximums and, of course, in any context there will be situations where, for good and proper reasons, a firm, because of locational or other factors specific to it, will face unit costs which may be higher, and I think it's important that the methodology has an arrangement that can reflect those situations. Whether that is by allowing people to report on an exceptions basis with the suitable auditing or expert opinions to support that, or whether that comes up at the control stage of the regime, is a question which needs to be addressed.

I mention these because in talking about the merits of ODV as the one methodology that would be preferable over the issue of either the other one or keeping with a choice, it's important just to note that there are still some things to do in terms of making that as ideal a methodology as it can be.

Like every principle, of course, there's also some exceptions and we've noted that Transpower has presented to you suggesting that indexed historic cost might be more appropriate for them and it's important, I think, to note some support for that view in light of the two specific circumstances that apply to Transpower, which are the grid

investment test and the important role that plays in perhaps taking the place of the optimisation process that might otherwise occur, or at least some parts of the optimisation process, and the difficulties that are involved in identifying standard unit costs for transmission which is characterised very much by one-off occasional assignments or occasional capital expenditure projects. Whereas, for a distribution business, it tends much more to be repeated application of similar things.

CHAIR: Just on that point, a few of the Lines Company have indicated some concern, not a difficulty with what you've just said but a concern to do with the fact that lines companies use a different approach than Transpower at the margin where assets might shift from one to the other there could be difficulties. I just wondered if you can see any problems, leaving aside at a principle level that it may be okay for Transpower, you can't see any issues for Orion if Transpower has a different valuation methodology than Orion?

MR SUTTON: Not off the top of my head I can't. You're right in that I think in general our assets are different. It's very much at the margin where they're in common.

I guess my concern would be, is the different valuation methodologies going to encourage or discourage you from buying, say, Transpower assets on the margin, and I can't see anything off the top of my head that would actually, you know, whether they use historic cost or ODV, that would drive that. I am not sure you should be striving to drive these regimes around those sorts of issues anyway.

I don't see any significant issue there.

CHAIR: If you look at the transcript and you have any further comments on that, just come back to us on it because I can't recall whether it was the Networks Association who

might have made a comment -

DR GUNN: I think it was ENA.

CHAIR: What was their precise concern, Calum, can you remember? It was ENA, that's right.

DR GUNN: I wouldn't know the precise concern.

MR SUTTON: There might be an issue in that if the historic cost for an asset might have been \$150 but it has an ODV of \$100 and Transpower want to go and sell it, we're going to say, hold on, we put this in our books, this is eventually going to go in at \$150, you know, there are going to be some issues there. I don't think that should be driving the regulatory regime, those issues as a first count. I think we should get the principles right and if we've got issues in those areas, let's go and fix it up later on.

CHAIR: We might ask you to have a look at that ENA comment. If there's nothing you want to add to that, that's fine. Thank you. Sorry for putting that on you, Calum.

MR HOUSTON: The next slide considers some of the choices that are available in the set of possibilities that might be available for implementing an indexed historic cost regime.

It's worth, before coming to that specifically, to just summarise the context to the choice that seems exists today.

It seems apparent in considering the most recent paper from the Commission on this asset valuation choice question that there's been some developments in thinking, as compared with the position I think it was in in December 2002 when the question of choice was first put up for discussion.

At that time there was a move from depreciated historic cost and now there's discussions about indexed historic cost, but there's another element where there

appears to have been some movement which I think is worth recapping on, and that is that the December 02 paper suggested that the ODV option would be - that people or lines businesses that chose the ODV option would be subject to optimisation risk and the latest paper doesn't mention this issue explicitly.

It does seem also to suggest that perhaps this wouldn't be the case. It sets out reasonably clearly at paragraph 97 that revaluation was to be treated as income and my at least on the surface reading of that suggests that optimisation, which is another form of revaluation, that the thinking is certainly consistent with that principle and would be that the optimisation risk would be incorporated as a form of income.

So, the consequence of that is the risk wouldn't, it seems, lie with the lines businesses.

In that context then, there seems to be two essential choices for implementing indexed historic cost. One is to develop it essentially as a measure that, if you like, mimics ODV as much as possible. To do that, you can actually imagine a set of assumptions or arrangements that you might apply to an IHC regime and those assumptions will need to cover depreciation, which is not discussed in any great detail in the latest paper, but also revaluations and the optimisation rules.

If you set in place a specific set of assumptions, then you would actually be able to replicate the ODV valuation by applying some specific assumptions to what you might call an IHC valuation.

That, of course, would secure the advantages associated with ODV but the flipside of that is you would no longer be offering a meaningful choice to businesses. So, that raises the question of why offer the choice?

An alternative would be to make sure that the details

of the IHC were implemented, particularly details on depreciation, on revaluation, on optimisation rules, or the prudent investment test which is the equivalent, to make sure that they were different to ODV in terms of the way they were going to turn out, and that would provide the businesses with a clear choice of methodologies.

It seems though that this approach would - and it's not altogether clear in the choice paper whether the Commission's inclination is to go IHC that turns out to be different, or whether we should have IHC that we try and keep as similar as possible. But if it is different, then that does raise the question, which is recognised in the choice paper, of not only giving up the desirable properties of ODV but establishing some of the problems with comparability of having two separate valuation methods.

So, given this convergence of methodologies, it seems to me that there are clear disadvantages to allowing a choice for the distribution companies. This is some of the disadvantages which seem to be the process of price and productivity comparisons which are intrinsic to the disclosure regime, as well as to the resetting of thresholds, and also to the control parts of the regime. They will become more difficult because comparisons across businesses over time will become less meaningful.

The assessment of excess returns, with two different methodologies of valuation, particularly in the case of mergers and acquisitions, would seem to become more difficult.

All of the comparisons that are undertaken in the normal processes of the threshold and control regime would seem to become more challenging and ultimately over time less valid.

It also introduces some additional development costs.

I have tried to think about, you know, what are the advantages? I've not really been able to - it's not clear to me what the advantages are. Indeed, it's not - I wonder whether it's a situation where whatever the reasons were for offering a choice two and a bit years ago, we now seem to have lost sight of what that rationale was in the first place.

The one meaningful distinction, which is who bears the optimisation risk, appears now to be being passed over.

I could be misinterpreting the Commission's thinking but if the differences in the question of the treatment of optimisation risk is to be left on the table and is to be elevated as an important dimension of that choice, then we need to understand it a lot better than we do at the moment.

The second part of my presentation on the asset valuation question relates to indexation and here, I think, there's room for some clarification about what the options are and how things fit together.

There's discussion in the paper about whether indexation should be based on the Consumer Price Index or whether it should be based more on the capital - changes in the Capital Price Index.

It is important in thinking about that choice to understand what we're actually trying to do and how the different indexing options fit together with other crucial aspects for profit measurement, which is both the form of WACC that you use and the treatment of revaluations as income or not as income.

I've tried to set out here a little table which I'll go through in a moment.

First of all, the purpose of indexation in regimes that use as the rate of return yardstick, use a real cost

of capital, so one that doesn't include an inflation component, is to preserve - recognises the need to preserve the financial capital of the business, if that is the purpose of the CPI in the appropriate index.

It is not necessary to use or apply both a nominal WACC and indexation of the nominal values to compensate investors because that compensation for inflation would be happening twice, and the way that mechanically that double counting would be avoided, would be to offset the implied income through asset revaluation for CPI by altering the revaluation or by accounting for revaluations as income.

I've set out how I think the three options fit together. The first row - I have three headings, Asset Valuation, WACC and Revaluations, what the revaluations rule is, particularly as to whether or not things are treated as income.

The first option is essentially the position as it is now, or as it has been over the last decade or so, which is that asset valuations, or have been to date, unindexed but for the step change that we had just recently with the development of the updated handbook.

Consistent with that, the profit measurement, the ROI measurement and all of the discussions and papers the Commission has put out on the WACC have discussed that variable in nominal terms. Your compensation for inflation arises through the cost of capital and that's quite consistent with having an unindexed asset value.

In that context, any revaluations which might arise through optimisation, for example, or through changes in the capital price over and above inflation, the Capital Price Index over and above inflation, any revaluations will be treated as income, and essentially that's what happens now in the ROI measure that's reported under the disclosure rules.

A second option would be to index the valuation, essentially what's discussed as a possibility in the choice paper, and of course what you need to do, or what you need to recognise, whatever index is applied to that valuation, if a nominal WACC is to be retained, then essentially every year that indexation would have to be - the amount of indexation that is applied to that asset value, and this is whether it's ODV or IHC, would need to be netted off the ROI figure because of the implied income through revaluation.

So, one of the things that you're doing in having a debate about which index, it seems to me the debate is perhaps less meaningful when you take into account that whatever we decide to add on on the one side of the equation, we're going to take off on the other.

One of the questions, of course, is the stability of that over time in terms of the reported ROI measure and that, I think, has been quite an issue which some people have raised and it's an issue which is reasonably obvious when you have step changes in valuations and what that means for perhaps significant variances in the reported ROI measure.

So, one thing, and this is a development from the submission that Orion made a few weeks ago, that we acknowledge, but one possibility would seem to me to be if there is to be indexation of the valuation, and let's say that indexation was to be for the CPI, then it might make sense in terms of getting a more smooth reporting of income to apply or to have that income tested against the real WACC, so that essentially we're shifting the accounting for inflation from the WACC to the asset valuation.

In that context, the only revaluations that would be treated as income would be those arising from changes in

replacement costs that were due to over and above, or under and below, the - if it was under, of course, it would be a devaluation, but changes in the replacement costs that were over and above or net of consumer price inflation.

I guess the sense is though, if you had an annual adjustment for inflation, then you would expect the need for some adjustment additional to that would be smaller and less frequent.

That leads us to summarise that debate by saying that the selected index should therefore reflect what is the role of indexation? What are we trying to achieve precisely?

In essence, if the nominal WACC framework is to be maintained, then there's no need to index at all for the requirement to maintain the financial capital. But of course there is a need to index if you choose - if ODV is to be the preferred method in order to make and retain ODV as being useful for the excess profits test, then you need to make sure that's up-to-date.

So, the consequence of that is that indexation of ODV would smooth the revaluations and would smooth the reported ROI between periodic reviews of unit costs.

We think that indexation of ODV can be met in two ways. One is maintaining the nominal WACC and adopt a capital cost index, just simply from the smoothing perspective; or to move to a real WACC and adopt CPI indexation.

Our sense is in thinking about this post the submissions and in light of the material that's been put before you in the Conference sessions, that it might be worth considering moving towards the real WACC and CPI indexation, so that the revaluation issue would be narrowed down to just replacement cost changes that were

different from the CPI.

To summarise then on the asset valuation question, I believe it is worth reconsidering the decision to offer a choice of valuation technique. It isn't so clear now why the choice was ever put forward and more importantly, why it's still being offered.

Just the existence of two possibilities would seem to raise questions about just the whole efficiency of the process of putting in place two different methodologies.

Of the two methodologies, ODV is preferable because it is clearly the concept which is relevant to the - it reflects the average cost of a new entrant and so it is the relevant concept for the threshold and control regime, and particularly the excess profits criterion or objective that comes in the purpose statement.

We think that for those reasons the ODV alone better would meet the Commission's criteria than offering a choice.

If a choice is to be provided, but I think this is very much a second best option, then that would be best achieved by having an IHC arrangement that mimicked, essentially, the ODV principles.

How that could all fit together in terms of bringing together the indexation and the accounting for revaluations and the income adjustment that's needed to reflect those, we wonder if it isn't time to think about accepting or adopting CPI indexation of the ODV values with periodic reviews to adjust those with respect to the actual replacement cost, but in conjunction with that CPI indexation to use or apply a real cost of capital in order to make the question about whether or not returns on those ODV values are excessive or not.

Thank you very much.

MR SUTTON: Now we're going to move on to Neville Ross who is

going to talk more from a practitioner's point of view. Neville does our ODV and has done that since the ODV process really was kicked off.

MR ROSS: Thank you, Commissioners. First of all, I'd just like to, from a practical point of view, just say why Orion favours ODV. It is principled, representing the costs faced by this average new entrant - that we understand a new entrant into our game would be faced with.

Greg has covered the economic principles.

It is established, developed and proven. We've worked with it since, I think, 1994.

It's matured over the years. It does need a bit of fine tuning.

It is a process which is inherently up-to-date. It's based on today's replacement costs which is not available from the historic cost approach and it is dynamically updated as long as we get those indexing or annual reviews properly in place.

It is a modular approach which gives us other useful network information. For example, we have to value parts of our network for the territorial local authorities for their district valuation roles and by having our asset values represented in this module away, we're able to identify those values for that purpose.

In our pricing work we have values that - we have pricing by connection category and we're able to identify the asset values associated with those different connection categories, and from our structured modular model that is very useful.

Another thing about pricing is we identify the peak component in our pricing in relation to the long run average incremental cost, the LRAIC, and we derive this directly from the optimised replacement cost which is

calculated as part of the ODV process.

The basis for giving credits for distributor generators also relates to that peak component. Because we can identify the costs associated with delivering load at peak through the main component, which is the asset value, we're able to have a sensible price that we credit to those that generate during our peak period.

From the ODV process we get meaningful economic depreciation. The total lives in the ODV process are pretty close to what are the useful lives, the realistic lives, of the assets, and it is this of course that gives rise to a realistic annual depreciation.

Lastly, there are clear efficiency incentives, the EMAs and optimisation are known to the company, they set a reference point when considering the cost.

Just a few points about why we would consider the IHC to be inferior. It doesn't satisfy this key valuation criterion of costs faced by the average efficient new entrant.

We consider there would be a high cost to introduce this. It's obvious it is a new basis.

We think it would take a lot more than five months to produce a new handbook and then provide adequate training and interpretation that we've been through in the last decade with ODV.

There would be many issues which we know from experience would have to be worked through.

This would lead to a high cost to administer. We would be faced with a new process and new principles to understand.

Having a choice doesn't seem to be cost-effective. We think that it might fail the Commission's own key implementation principle, as expressed in paragraph 50 of the discussion paper, where it says that the process

should achieve a regulatory valuation objective at a reasonable compliance cost and, clearly, if the result is the same as ODV, it would seem to be a little futile and no point in having a choice.

In terms of managing the ODV process, we agree that five yearly certified ODVs with annual interim updates will save costs, that compares with the three yearly mandatory ODVs that are required under the existing rules.

Indexing is appropriate for the interim years and, as Greg has explained, it will enable smoothing of the disclosed ODV and ROI measures over time.

We consider we should place considerable reliance on the role of the auditor. We think we should rely on their expertise. They do assist in achieving consistency in interpreting and implementing these ODVs.

We just want to stress that they develop the specialist expertise with their knowledge and understanding of the handbook rules and also the key features of our network.

MR SUTTON: From here, with the consent of the Commissioners, we will move on to the information disclosure and Mark is going to lead off here, just talking about really the legal issues. Welcome Mark.

DR BERRY: Thank you, Roger. I have reduced my comments, which are relatively brief, to a short paper which has been distributed and hopefully that will ease the communication process as I go through.

The Commission has quite clearly broad powers to require information disclosure under sub-Part 3 but inevitably the problem is to identify appropriate boundaries which must inevitably be drawn.

I go through three main headings to identify some of the key principles that will inform the Commission in this exercise. The first is the overall statutory scheme of

sub-Part 3 within the scheme of Part 4A. There is an overriding principle of relevance that I think is worth noting explicitly. It is recognised in the Commission's discussions paper but I simply note the Telecom judgment and those principles which seem non-controversial to me and to go through the three key points there. The Commission does have limited power to require the furnishing of information, inevitably there are limits to the power which are to be considered in the context of the empowering provision.

The primary right to assert relevance lies with the Commission but nevertheless it is open to challenge.

The Commission's assessment of relevancy in any case.

I will come back to the assessment of relevancy principles a little later on.

Briefly, what information is intended to be covered by sub-Part 3? It seems to me there are two key guiding sections within sub-Part 3 which are again recognised in the Commission's discussion paper.

The first is section 57T which, in my submission, has two parts. The first is the overall purpose statement, namely that the information disclosure regime is to promote the efficient operation of markets directly related to electricity distribution and transmission services.

Then I characterise the second part of section 57T as a description of the means by which that option is to be achieved.

The provision says the Commission is to achieve this goal by ensuring that large line owners and large electricity distributors make available information about the operation and behaviour of those businesses, that is as line owners and electricity distributors.

And secondly, this information must be remembered in

the context that it is potentially to be made available to a wide range of persons. There's a very broad category of information which is anticipated by section 57T.

Section 57T is also complemented by section 57V, which again requires the Commission to publish the outcome of information disclosure. In this context it is to promote greater understanding of the relative performance of individual line owners and electricity distributors.

So, in that sense it has a clear comparative goal in the way that that prescription is developed.

So, again to emphasise, these are on the face of it wide information gathering powers but inevitably there are limits.

The starting point that I raised there is the reference throughout sections 57T to the fact that the information must be related to what may be the term regulated business in the way some of our discussions have been developing, and that is to say in relation to the business of line owner and electricity distributors.

I go on to run the argument there that inevitably there's no question that that is what information disclosure regime relates to.

However, as the discussions progress, there has been the somewhat more vexed question about what has been termed non-regulated business activities in the context of cost allocation issues.

Initially you'll see in paragraph 9.4 of my paper I address the way that the Commission I think addressed it in the discussion paper to us, asserted that via sub-Part 1 there was the ability to obtain so-called non-regulated information, and I set out a number of reasons as to why in the context of the information disclosure regime I think that proposition is not right. But I don't linger on it for present purposes because I

understand from the session held with Powerco on Thursday that the Commission now seeks to rely upon section 57U(1)(b) to support its claim that it can obtain the so-called non-regulated information.

I think that proposition is correct, that there is clearly this ability for the Commission to pursue non-regulated information so far as it relates to the regulated business operations of electricity lines businesses.

But I go on to state that there are a number of comments that still need to be made as a caveat of that acceptance.

The first is it has to be remembered that there is a clear distinction between the two roles of information disclosure, where the parties come forward and disclose information that will in that context be made publicly known, versus the other work stream which is information required by the Commission for monitoring purposes under section 57U.

It seems to me, these are two clearly separate work streams and have to be thought of in that context.

The second point that I raise is disclosure of information concerning this non-regulated part of a business may be unnecessary and inappropriate where the Commission has other adequate means to verify the information in question.

Again, this was touched on in the session just before with Marlborough Lines relating to the role of the auditing process.

It seems to me the Commission ought to be urged to rely to the extent it can on the auditing process. I think it has a preference to it. I must confess I haven't given this detailed consideration as this issue really only arose in the context of last Thursday but it seems to

me that there is a problem going too far into this issue dealing in the abstract but if it is possible for the Commission to frame its request relating to information disclosure in a way that sets the rules about how it would want cost allocation done, then that is a matter that could properly be done solely on the basis of an auditing approach to this issue.

Clearly, if there is confidence in the integrity of an auditing process, I would see no difficulty with that alone giving sufficient comfort to the Commission.

The converse of that is that there may be risks for the Commission in taking a different position of trying to seek out a good deal of so-called non-regulated information. How would the definition of the request be made? Is there a real risk that non-relevant information would end up being required to be disclosed to the Commission?

It's hard to take the argument much further without actually having a specific example before us but I think there are those real risks of non-relevant information becoming potentially at issue if, in fact, the Commission's information request extends into non-regulated business information.

One final point on this auditing issue. It does seem that there would end up being a duplication of process which would, in one sense, be inappropriate and inefficient. It seems unnecessary for me for the Commission to be performing the role of auditing the auditor if that is all that is entailed.

The final limit I note is section 57V, all of those earlier comments relate to section 57T. Under section 57V the disclosure requirements clearly talk about the relative performance of the different line companies and again, as I mentioned before, that brings in simply

questions of comparison.

A further signpost in working out what ought to be subject to public information disclosure is the relationship of sub-Part 3 with sub-Part 1.

Notwithstanding that sub-Part 1 stands alone with its own purpose statement, some guidance as to its application can still be gleaned from sub-Part 1.

The first point I make is that sections 57E and 57T share the same central purpose statement. I think we can read something in from there, that where section 57E says that the efficiency goals of that provision are achieved through targeted control, it seems at least arguable that the same efficiency goals of section 57T may be achieved through disclosure of information which is no more than is sufficient to meet the targeted control regime requirements.

The further point I note is that the subject matter of section 57T, that is information about profits, costs, assets, price, quality and so on, these presumably share much in common with what will always be necessary to make sub-Part 1 operational.

From that it does not necessarily follow, however, that sub-Part 1 information requirements are necessarily a subset of what ought to be disclosed under sub-Part 3.

In practice, there may well be a close relationship between the information disclosure requirements under sub-Part 3 and sub-Part 1 for the reasons I've just mentioned but the Commission still nonetheless has to stand back and ask the question about what remains appropriate to meet the particular purpose of sections 57T and 57V. It is possible that the Commission could go narrower than what you would require for sub-Part 1 in order to impose information disclosure requirements on the electricity lines businesses.

That submission leads into another allied concern that may arise, and that is to say the relationship with sub-Part 3 with other information gathering powers. I simply note in those paragraphs of my submission that the Commission clearly has much wider powers beyond sub-Part 3, both in the context of assessing breaches of thresholds and in the imposition of control. In particular, I refer to sections 98 and 70E.

Ultimately, when the Commission stands back and thinks through what information it's going to require in terms of this public information disclosure, it comes down to what I call simply a judgment call. I set out what I think are relevant questions that the Commission has to think about when making the judgment call.

First of all, would disclosure be meaningful? What is being achieved by a disclosure?

Secondly, is there a nexus between the information to be disclosed and the goal of section 57T, the promotion of efficient markets?

And then finally there is the issue of compliance costs. That is an issue that's been variously raised.

It seems to me it would be inappropriate to impose the same level of compliance costs on all businesses whether or not they be in compliance with a threshold regime.

So, in summary, as a suggested way forward, I put forward the following proposition, that the Commission may set the information disclosure requirements on the basis of, first of all, information that is no more than is necessary for the operation of the targeted control regime, and I say that largely in response to the Commission's tentative conclusion that this is simply a subset of what may be required; and then is the add on under section 57V, it is possible that there may be some

other comparative data that serves a particular purpose which may be in addition to what you would require under section 57T.

Those are my comments -

MR SUTTON: Do you want to ask any questions at this point?

CHAIR: I would like you to continue until 12.15 and then I'm going to ask Commissioner Hemmingway to pose questions. I would like him to hear as much of the presentation as possible.

MR SUTTON: Greg, if you want to carry on the discussion on the information disclosure issues.

MR HOUSTON: Sure. This is an economic rather than strictly legal interpretation of the role of information disclosure and how it should fit with the thresholds regime.

The overwhelming conclusion of thinking about this is that the information disclosure and thresholds regime should be complementary. That is recognised by the Commission but perhaps to maximise the ability of the regime to meet the common goals of the two things, which importantly have efficiency as their common goal, it is worth, it seems to us, focusing on the development of the disclosure regime on the relationship with both the threshold and control regime.

The control regime, the targeted control regime, provides a framework essentially for assessing information and performance. The important thing about that framework is that it has a set of, sort of, thresholds, reporting on those and then potentially actions or responses to those, and it's the actions or potential actions in response to those that really gives the regime its teeth.

The information disclosure regime surely increases the probability that unacceptable conduct will be detected and it may also be that consumers' use of disclosed information may provide some form of additional constraint

on lines businesses, economic constraint on lines businesses, but for the most part I am reasonably sceptical that that's going to have much substantive effect.

The real teeth behind the regime seems to me lies in the threshold regime and the control regime that sits behind it.

It has to be acknowledged that consumers and other interested groups may find the information useful but it's difficult to imagine why that information or why the role of consumers and other interested parties finding information useful, why that function would warrant a wider or different set of information being provided when efficiency is the common goal, and many of the things that are enumerated in the purpose statement for the disclosure regime, all of those things seem to me are relevant for at some point in the process operating the threshold and control regime.

MS BATES: Did you say are relevant or are irrelevant?

MR HOUSTON: No, relevant, sorry. That is a very important clarification.

In working through the details of the information disclosure regime, I think there's room to go further in perhaps recognising this complementarity.

The principle set out in the disclosure paper is the efficiency objective and then there's discussion of different approaches or different issues in information disclosure by reference to the allocative, dynamic and productive efficiency, which is certainly consistent with that over-arching objective, but I think when it comes to very practical matters, like what's needed and how should it be reported, it seems to me that those things don't perhaps tell us as much as we really need to and a good deal of guidance can be found by focusing on what is

required to make the threshold and control scheme operational and I think it's by focusing on that, that you're more likely to come to a clear conclusion as to what is the best information.

The next few slides discuss some of the additional design principles which are, in many ways, quite operational in nature and just highlight some specific issues that seem to us to arise from that.

As I said, in terms of the relevancy, it seems that the most important thing for the disclosure regime is to focus on information that is relevant to the threshold and control regime because it's that regime that is linked to actions or penalties underneath it, so the likely behavioural change or constraints that need to operate on the lines businesses arising from their natural monopoly status. So, that means information relating to the adherence to the price and quality thresholds; information that goes to the likelihood of control being declared in the event of a post-breach assessment; and information that also helps to inform how ELBs performance will be viewed at the time of the next threshold reset.

The high level implications of these principles, I have set out a number of those here because at this stage we are still talking at high level things.

For example, if you look at the disclosure arrangements at the moment, I think this is certainly an issue which the Commission itself has identified. There are three different methods currently for reporting returns and, as sort of somewhat of an outsider, it seems to me, first of all, it's pretty unusual to have more than one and those three are in all kinds of ways quite complex and the distinctions between them are quite fine.

One important distinction is between the ROI measure as distinct from the return on equity and return on funds,

is that they both involve assumptions or information on capital structure of the lines businesses.

I think it's a general principle for regulatory regimes, particularly those that are at the lighter handed end of the spectrum, which this one clearly is, that information on lines businesses, capital structure, really should not be important for the operation of a threshold and control regime. That information is generally not asked for, for example even in Australia which has a regime characterised by regimes that are more in keeping with, sort of, permanent control.

Shall I pause?

CHAIR: Just pause for a minute and I will just ask

Commissioner Hemmingway if he has any questions.

MR HEMMINGWAY: Yes. If I could go back to the valuation methodology and ask a question that Mr Houston could comment on.

With respect to the choice of valuation methodologies, does it matter at all what choice Transpower makes, including ones which you have not chosen to recommend, such as the unindexed with a nominal WACC, or even a depreciated historical cost; would it matter at all which methodology was chosen for Transpower?

MR HOUSTON: I haven't thought carefully about that choice for Transpower and I think I'd make two points.

First of all, each of those methods is equivalent in net present value terms. So, in that sense, it doesn't matter either for Transpower or the ELBs, for that matter.

What does distinguish them is the smoothing of the reported returns and the changes in valuation over time.

I am not sure that I am in a position to answer the question of how important that is for Transpower, I just don't know enough about their situation.

MR HEMMINGWAY: If I could get a little ahead of where you are

with respect to information disclosure, switch gears a little bit. How many different businesses does Orion have involvement in that are ones that are in competitive fields of enterprise?

MR SUTTON: We have our largest investment up until now which has been in a company called Energy Developments which is an Australian renewable energy developer. We had about \$70 million or \$80 million invested in that business. We have recently started to sell down our shareholding there but that's an investment. So, you know, I'm on the Board.

And then we have investments in a contracting company, which operates at an arms-length basis. It reports to a separate Board and so on, it turnover about \$25-30 million.

And then there's a whole - there's a range of other technology companies, many of them are involved in the energy centre, a company called WhisperTech that does small home care generation stuff. We have some money in some other Canterbury businesses doing small energy development and so on.

But so far as the energy development Connectix, the other are much smaller by comparison.

MR HEMMINGWAY: Thank you. That's all.

CHAIR: Continue with the presentation, thanks.

MR HOUSTON: Sure. Just to recap on this slide here, the high level implications of the principle of relevancy, I just mention that I think it's hard to imagine that detailed information on capital structure of lines businesses is relevant to the threshold and control regime, or even relevant to the interests of consumers that may be wider than the threshold and control regime.

The second point is that there seems to be, as a general principle, fairly limited benefits to the scope of the disclosure regime being wider than the threshold

regime, unless of course, as has been discussed already, if that is providing information which is useful to the regulated component and specifically how costs are allocated to that.

One of the questions which has arisen is whether or not information should be provided on a disaggregated basis to distinguish customer classes and geographic areas, and that is certainly raised in the Commission's paper but it's unclear to me what the objective would be of providing that information, and it seems to me there's a significant risk in seeking that information, a debate if you like about various forms of distributed cost allocations which has fairly limited economic or any other merit.

The information that is provided would be subject to quite difficult and ultimately arbitrary decisions on the way costs should be allocated and then it's not clear what the recipients of that information will be able to do with it, recognising its limitations.

Breakdowns of operating expenditure. There's some quite detailed breakdowns provided at the moment and it seems the relevance of those is quite questionable and breakdowns of some sort would be useful but they should be quite carefully thought out and limited to what would be meaningful and useful to the operation of the other parts of the regime.

And then finally, I know there's been some debate or questions raised about the role of actual tax paid by the statutory entities that own these businesses and also the capital financing arrangements of those.

I would put the principle that that kind of information is unlikely to be relevant to either threshold or control decisions and that when it comes to taxation information, in particular, then it's better for

regulators not to open the Pandora's box of how the legal entities tax arrangements are arrived at, and preferably to have some kind of synthetic benchmark taxation calculation that's reported.

Continuing on with the principles, consistency is an important one that's being established and clearly inconsistencies between approaches will limit the ability to interpret conduct and performance, particularly across businesses.

And I think this is an important principle for thinking about the valuation choice issue.

It's also been a big issue with the current disclosure regime, as highlighted by the analysis undertaken by Meyrick & Associates in the context of the last threshold reset.

So, it's very important to develop the regime in a way which improves the consistency between entities and the comparability. That improving consistency across the businesses, I suggest should take priority with maintaining consistency with past practices. That it's better to have a regime that's of a higher level of consistency going forward than it is one that has consistency over time.

In very high level terms, it seems the way to improve the consistency of the arrangements would be to require or develop greater specificity in some areas of the regime, so that it's clearer what is and the basis on which things are to be reported and the assumptions that should be made or are to be made.

In other areas a reconsideration of the usefulness of some things.

So, in very general terms, I wouldn't see necessarily a reduction in the amount of information that's provided but perhaps there would be a reduction in its scope and an

increase in its depth. So, greater specificity over a narrower range of variables seems likely to provide an improvement.

Examples where that might be relevant are the treatment of customer rebates and discounts; cost allocation between regulated and unregulated activities; quality performance and productivity measures.

One issue that's drawn quite a bit of attention on is the cost allocation issue and the Commission's paper expresses concern with the use of ACAM, including that one of the bases for that concern is that it's inconsistently applied.

That, in particular, seems to me like a very valid concern and all economists that have ever flirted with the application of the principle of incremental cost will know that there's a lot of issues that you have to deal with in figuring out whether something is truly incremental, including the relevant timeframe to consider that.

The Commission also makes reference in its paper to this perhaps allowing subsidisation of competitive services and I do wonder if that concern isn't a bit overstated.

ACAM is directed to preventing cross-subsidisation, at least as far as economists have to say about what ACAM is and what it means because what it implies is that the costs that are allocated to regulated activities are no higher than the stand-alone costs of conducting those activities.

It also means that unregulated activities are allocated or bear at least the costs that would be avoided by the lines business.

So, ACAM is the relevant concept for assessing the costs incurred by a provider that's unable to recover shared costs through other activities.

And so, its role and its consistency with the wider framework seems to me that it fits well with the concept of the stand-alone and efficient new entrant.

And so, it has a natural link to the excessive profits criterion that's in the purpose statement.

Having said all that, I would be the first to acknowledge that ACAM, and indeed the application of any incremental - of the incremental cost concept in any context, is one which necessarily involves some thought that's often outside the square for accountants and the people that normally produce GAAP or accounts. And so, some further guidance on that area would, to my mind, clearly improve the consistency between businesses. Particularly, say, for example, the allocation or the treatment of corporate costs.

ACAM needs to be implemented in a way that reflects the objectives of the regime and both efficiency and excessive profits in particular.

I think it's worth noting that there does seem to be, from some parts of the discussion paper, uncertainty about what those objectives of the regime are and I draw the Commission's attention to two particular aspects which to me sit a little uneasily.

The first is that I think it's paragraphs around 243/244, the Commission talks about the principle that small lines businesses that don't reach some scale efficient standard should bear the costs of that scale inefficiency. It's not - it also mentions that the whole process in the discussion of the mergers and acquisitions, that the costs involved - that mergers and acquisitions are essentially a risky activity and both the costs and the benefits of those should flow to shareholders rather than to consumers, or do flow to shareholders rather than consumers, and so should be netted out of the disclosure

principles.

I think while at one level it's easy to understand those sentiments, it does seem to me that in an information disclosure context those principles would lead you down a road that I suspect would be quite difficult practically, where essentially you would be asking for, or I think you would be implying, that people would be reporting costs on a synthetic basis.

For example, if a small lines business is 10% inefficient, for example, would it be reporting its costs as 10% lower than they really were? Or if there had been a lines business that had merged with another lines business and had become more efficient as a result, would it be reporting the costs as they occur for the merged entity, or the costs that might have been incurred but for the merger?

The paper clearly doesn't take that extra step but I do see that as the implication of the principles that are suggested and I think that would present some important practical difficulties.

On the other hand, the paper also expresses concern that economies of scope should be passed on to consumers in the discussion of the ACAM principle and I think that to me doesn't sit easily with the principles that are discussed in relation to the small lines businesses and the mergers and acquisitions.

So, on that area I think it's important to try and clarify what the goal is before the precise information disclosure requirements are settled.

Just finally some principles that are more operational in nature. Transparency, that's quite an easy one to accept I think and apply because disclosure intrinsically involves transparency, although, as I've already discussed, some of the information on the

different measures of return, for example, it is a good example of information that, if anything, seems to reduce the - maybe not transparency but the understandability and the usefulness of information.

So, it's important, as part of assisting the transparency objective, to weed out information which doesn't seem to add very much.

Cost effective is clearly an important principle and that goes to the whole question of relying, as far as possible, on information that's already produced. Consistency with GAAP is helpful but I think it has to be acknowledged that that shouldn't be at the cost of relying on information that's less relevant.

And it needs to be said that sometimes the regulatory context will necessitate information which is additional to or elaborates on that that you can find under the GAAP approach.

But also there's a need for caution in requesting breakdowns, as we've already discussed, measures that are perhaps inconsistent with the way that firms do business unless it can be established that that's very important for some aspect of the regime.

The last but one slide is the question of accuracy. There's been - I mean, clearly the information should be accurate and that puts great weight on the auditing and verification of that information. I think it's very important in remembering that information, if it's not consistent with reasonable data collection practice, or there's unclarity about, for example, the principles or the application of the principle like ACAM, then it's very hard to expect to get accurate information if it's not precisely clear what it is that's being provided, and I think the possibility of seeking costs by geographic region is a very good example where you might get a lot of

data but I don't think you would receive a great deal of useful information.

Just to summarise then my contribution on the disclosure question. It seems the best opportunity for achieving an effective disclosure regime lies in recognising the interdependence between it and the threshold regime. The threshold regime, and I also mean the control part here, defines the bounds of acceptable behaviour and sets in train a whole lot of processes and actions or reactions which is fundamental to the constraint that it provides.

It seems that that's the first and overwhelming important thing, is to have the disclosure regime serving that purpose.

That relationship also provides useful guidance on the design of the regime, in the sense that all the relevant information is disclosed in a way that should be accessible to interested parties. I think there's a lot to be said for the relative inaccessibility of the disclosure information at the moment. Of course it's available on websites but untangling it myself as part of the preparation for this and on other occasions over the years I've found it really quite difficult to understand what exactly is going on and that's an important thing that could be developed.

As well as minimising at the same time as part of that process extraneous information, that simply mixes the messages.

That's the end of my section, thank you very much.

CHAIR: Thank you. I thought we might just take a few questions now, if you don't mind I would like to do that.

I will just start with one. You talked a little bit about not opening up Pandora's box on tax, using some synthetic calculation. I take it from what you said that

you're emphasising the simplicity of this approach, or is it based on some underlying principle that you're suggesting this?

MR HOUSTON: It is not simplicity alone because I think there are important principles as well. For all - I mean, the legal entities which operate the lines businesses may and do have involvement in all sorts of other activities. There may be other regulated activities but I think it's easier to think and focus on their unregulated activities.

The taxation implications of those, and even the - I mean, particularly going from the experience in Australia, which I'm sure is replicated in some instances here, very complex corporate structures owning these, businesses range from trusts to - and I don't mean just the trust owned businesses here but trusts which are setup as listed entities in order to improve the tax position of these entities, even if they don't own other businesses.

Once you step into trying to understand that area, it's sort of like going somewhere that it's very hard to come back from and you really have to ask the question why is it necessary to do this? Isn't it better to just assume that you've got a simple stand-alone business conducting these functions and to look at what the tax position is for that business, assuming that it paid for those assets what is the regulatory asset value.

So, that's a principle, I think, which is important.

There's a second - and that also assists simplicity.

There is a second principle which I think as soon as a regulatory agency starts to get involved in understanding, and potentially underwriting in terms of the control and threshold decisions that are made in terms of decisions that are made or allowed on the prices that may be charged to customers, then you have an implicit buy in from that regulator to the capital structure

arrangements that exist. Now, some entities have much more risky capital structures than others.

We've had some businesses in Australia that are pipeline businesses that have paid too much for those pipelines and have been forced into administration, for example. You know, there are all sorts of complicated consequences arising from that and I think it's much better if a regulator can say, well look, that's nothing to do with us, we haven't sanctioned that, we haven't authorised that, it makes no difference to the prices charged, whether this firm has debt that's double its regulatory asset value, or debt that's half its regulatory asset value, that makes no difference to customers.

If the regulator is in that position, then it's very easy to stand up and say when business X, Y, Z runs into financial difficulties that there are no consequences for the customers, and I think that's a very strong and enviable position to be in. Rather than people saying if this business is broke, isn't it your fault, or aren't you complicit somehow in that outcome?

CHAIR: They still say that in Australia though.

MR HOUSTON: Well, that's for different reasons. They say that but no-one - that's for different reasons because people - that's the normal process of people wanting to take issue with regulatory decisions.

The best example is the Dampier to Bunbury pipeline which went into administration, was sold, at no stage did the gas stop flowing along that pipeline. Of course there was a view by the owners that it was all the fault of the regulator for setting prices too low, but there's also a good deal of commentary that says, well, a large part of the problem was that someone paid too much for that asset and irrespective even of which of those things is right, if you stick with the principle that the regulatory asset

value is the thing to focus on for the regulatory decisions and how that is financed and how much debt sits alongside that is of no interest to the regulator, I think that's a happier place to be when those problems arise.

CHAIR: I just had another question on the ACAM. You indicated at present there's uncertainty about the objectives we're trying to work to here. You talked about a range of issues from retaining some incentive for efficient mergers and acquisitions but also the need to pass on benefits to consumers. It does seem to me there's something between the two and most regulators try to find a way of allowing those benefits to be captured, at least for a period but eventually requiring them to be shared.

I know that a large infrastructure company once told me they figured they could keep those benefits for two and a half to three years and that they would expect them at some point to be then shared with consumers and that's how they based their bids on the assets. It seemed fairly reasonable. Last week we heard about the sharing world that said keep the benefits for five years but then it gets, you know, taken out and passed on to consumers.

You didn't actually say what you suggest, you indicate you think we need to provide more guidance and I just wonder if this is an issue that you've looked at? I mean, when you say "provide for guidance", what sort of guidance do you think we should provide?

MR HOUSTON: I think in this area there's an important distinction to be made in any discussion and that is between efficiencies or, in technical terms, economies of scale or economies of scope actually that arise between the ownership of a lines business and the ownership of some other business, maybe the kind that Roger Sutton has just been talking about.

In my view, there's very limited reason in economics

to support the principle that, for example, the profits or losses that may fall to Orion is a consequence of buying and then selling its stake in a listed entity in Australia. It should have nothing to do with the customers of a lines business in Christchurch.

So, on that front, where you're talking about businesses which have nothing to do with electricity lines, I think it's a very hard position to suggest. It's very difficult to find any principles that say there should be sharing of those costs or benefits with the customers of the lines business.

Then you have the question of efficiencies arising from a merger or consolidation within the lines business sector. On that aspect, I think you've got quite a different set of circumstances and principles in front of you.

I don't think there's any sort of case in economics for saying that if there are economies of scale between merging one lines business and another, that there should be a regime that essentially allows the shareholders to retain those forever. If there are economies of scale, and they can be achieved, then it seems right to me that two monopoly businesses in the same industry, they should fall - the benefits from that should eventually fall to the customers but, of course, you need to be very careful not to make that happen too quickly, otherwise those benefits won't be gone after by the people who are willing to take the risk in the capital market.

So, it's on that area that you arrive at sharing rules of the kind that were discussed last week in front of yourselves and have been canvassed quite widely in many other jurisdictions and there are five year sharing rules, or sharing rules that essentially say whatever the gains were they should be kept for a period of time.

I think, in summary, it's very important to distinguish between efficiencies that may or may not exist between a lines business and any other activity that's outside the lines sector and efficiencies that arise from consolidation within the lines business sector. They are two quite different principles that should apply.

MS BATES: I have a few questions for Mark. It's most useful to get your outline and I have had a chance to have a look at it in the break, so there's quite a lot of common ground actually between us.

I just want to clarify some issues. Where you say there's two provisions which provide guidance on information intended to be covered by sub-Part 3, my view is that there are three and that section 57U(1)(b) comes in because that refers to the monitoring role of the Commission and that information relevant to monitoring is also one of the key provisions; do you agree with that or not?

DR BERRY: I accept that. I think it is consistent with what I've said, in that when I'm referring to the information covered by sub-Part 3 I am referring there to information in the public disclosure situation.

So, 57T and V is the relevant statutory provision relating to information that you seek for the actual disclosure purposes and there is the follow-up work stream as need be under section 57U in relation to monitoring that.

So -

MS BATES: Yes, but that information may well go wider than the other two provisions?

DR BERRY: Correct, it could well do but I accept there is that third part to sub-Part 3.

MS BATES: One argument I just wanted to put to you is this, whilst accepting that the publicly disclosed information

is information relating to the business of electricity lines, would you agree that where it comes to the reconciliation information, that that is actually relevant to the business of electricity lines, although it concerns the unregulated business as well? The argument is to give an accurate picture of one, you may have to look at the other.

DR BERRY: If we take, for example, cost allocation from a regulated business, then that would appropriately be factored into the public information disclosure.

MS BATES: No, no, no, I am just wondering - it comes down to this, perhaps the information that you gather to get there might not be publicly disclosed, there's no obligation under U(1)(b) to disclose it, but there is an observation under V for us to analyse and publish summaries.

DR BERRY: Correct.

MS BATES: And it may be that if there is an unresolved problem about costs allocation, that we would want to reserve the right to be able to refer to it.

DR BERRY: I am thinking that through. I find it difficult, thinking through a lot of these issues in the abstract, and I think it becomes a lot clearer when we actually have fact examples before us.

It may well be that information disclosed under section 57U is in some way factored into what is the relative information to be disclosed for public information disclosure purposes subject to addressing confidentiality issues.

MS BATES: Yes, that's really what - I am just trying to say, it's quite hard to draw an absolute line and say, this is the monitoring information, this is the publicly disclosed information. There's a point at which they cross because you're doing a monitoring role.

DR BERRY: Yes. I think the two work streams have to be always

kept in mind and I agree, there will always be the issue of where the intersection lies and how that is handled.

MS BATES: Yes.

DR BERRY: But I think that is something that all we can say is it's going to happen on a case-by-case basis.

MS BATES: It's just a question, coming back to the auditing proposition, that you work out the methodology, I think that's more or less what you are proposing, and that having done that, then you accept the auditor's view on what the situation is; is that more or less what you are saying?

DR BERRY: I think there's not a great deal of point. Unless there is confidence in the integrity of the auditing process, to some extent I wonder why we would go there if, in fact, there was always going to be a reluctance to accept that at face value.

It seems to me that if there is the ability to say we want this public information disclosed and this is the methodology, for example, of doing the cost allocation in relation to a non-regulated business, it seems to me there is a strong case for having reliance on an auditor for saying they have looked at the relevant information and satisfied themselves that an appropriate cost allocation has been made.

I say it is open to the Commission to be satisfied under section 57U.

MS BATES: Yes, there's still power there to verify the auditors if one thought that was -

DR BERRY: Correct but I'd always start, I think, with having the audited position as a starting point.

MS BATES: You said in your submissions to us that you hadn't given a great deal of thought, I am not saying you should have, a great deal of thought into what that process ought to be. I am saying it might be relevant to put your

thinking in writing to us.

MR SUTTON: We will.

MS BATES: It might be helpful to us.

CHAIR: I think that's right because the Commission has had some experience of finding the audited results not correct. So, putting to us that we should be able to rely on them or have comfort relying on them, well it may not have been our experience to date in all circumstances.

MS BATES: Just to pursue a theme about relevance because I am not quite sure that I am clear with you on this, that we shouldn't be going - in sub-Part 3 we shouldn't be going beyond what is relevant to our role under sub-Part 1. I think that was more Mr Houston's point actually, was that it's a co-ordinated regime but to decide what's relevant under sub-Part 3 we should really be focusing on what's relevant under sub-Part 1. I don't care who answers this question but I just needed to understand a bit more about what you mean there?

MR HOUSTON: Perhaps I will give an economic argument which -

MS BATES: I am more likely to understand than a legal one.

MR HOUSTON: I couldn't rightly guarantee on that but it is important to distinguish between what I'm about to say and the legal position which, as a non-lawyer, to me is complex and I don't pretend to understand it all.

It does seem to me that you have to ask yourself in thinking about clearly the threshold and control regime requiring information and so it has to be right that the information disclosure regime should provide that.

The information disclosure regime does also make reference to other information, I think that's also clear. But what I find difficult to reach a, sort of, answer on is what sort of information is it that would be useful, and to whom would it be useful to and why, that wouldn't normally be required and provided to operate the threshold

and control regime?

As an economist, I find it difficult to understand what would be in that set of potential information that I have. I don't think I've seen any, sort of, convincing proposals, or even any clear proposals, about what that would be, even though I accept that is a theoretical possibility but I don't have any grasp as to what would, as a matter of practice, be in that information.

MS BATES: If you go back to the purpose statement, it talks very specifically about profits, costs, asset values, then price, including terms and conditions of supply, quality, security and reliability. I mean, is there anything there that you think goes too far?

MR HOUSTON: I think all of those things would be relevant to the threshold and control regime.

MS BATES: Yes.

MR HOUSTON: So, in that sense, they seem like relevant subject headings.

MS BATES: It is drilling down into the detail, I suppose, is that where you're -

MR HOUSTON: That's right. Nothing that I've seen or heard, no-one has presented me with an example saying, here is a piece of information that wouldn't be necessary for the threshold and control regime but would be really useful to some of this theoretical set of people outside of it and why would it be useful to them? What would they do with it? I don't have any clear grasp at all about what would be in that information set.

MS BATES: Well, I mean, an example for you is the disaggregation point.

MR HOUSTON: Yeah, I don't, and I think I've made it clear that I don't see that that's going to be very useful for either - I think it's going to be complicated and controversial for the people asked to produce it and because it's

relatively arbitrary, I don't see how it's going to provide particularly the allocation of costs on a geographical basis. It may be that there's quality information that could be differentiated, I would accept that, but that's quite probably relevant to the threshold regime as well because, I mean, other jurisdictions that regulate or discuss quality issues and that control quality issues focus not only on the averages but the outliers. I don't have any problem with that. I would see that as a natural development in the threshold regime.

But when it comes to allocating costs and revenues, I think that's a slippery slope that does not take anybody anywhere very usefully.

MS BATES: Okay. I think that's it.

CHAIR: Can I just ask if Paul is on the other end of the phone? Paul, are you still on line?

MR SELL: I am still here, Paula.

CHAIR: Would you like to ask any questions on the material you've heard thus far?

MR SELL: Yes, I would. Perhaps just before I launch into some questions because I do have a few and they may lead to some quite lengthy answers I'm afraid and I am conscious of time at your end, can you give me some indication perhaps as to what you might like to do now?

CHAIR: Well, Orion wants to finish before the lunch break, so I've assumed that we will carry on probably until 1.30 if the transcribers can keep going.

MR SELL: Okay. Well look, I'll ask some questions now and if you'd like some to be abbreviated or held over to cross-submissions, then please indicate that.

I think the first question I have is going back to the valuation presentation that you gave, Mr Houston, without pre-empting any decisions obviously that the Commission still needs to make on those, I would say I

think we're on the same page in regard to the explanation of the factors influencing those decisions and I think what you presented was very helpful to us.

Really my questions are only on the detail. My first question is about the indexing issue because what you seem to be proposing in the end is the CPI is at odds with Orion's submission, which was for, if I read it correctly, a specific index.

I guess the first point I'd just like to get clarity with you on is that in my view the CPI indexing is really just a specific case of the more general case, where one accepts that revaluations, whether they're at CPI using some other index, are deducted from what might otherwise be considered as a nominal rate of return. Is that also in line with your understanding?

MR HOUSTON: Yes, it is. Indeed, in fact, that is exactly what happens under the current disclosure regulations for the ROI measure, that is certainly as I understand them.

MR SELL: Yeah, so we have the same general case going forward as we've had in the past, it's just that the difference going forward is that we may have - well, we will have ongoing revaluations as the regime has potentially had in the past but now we're talking about having annual indexing which will simply smooth things out?

MR HOUSTON: Yes, that's right, although if you adopted the combination of a real rate of return and CPI indexation, then that CPI indexation of the asset values would not need to be deducted from the reported ROI measure because that is a form of income that needs to be earned because you've netted out the CPI component of the WACC.

MR SELL: True, true. That's all in the mechanics but the net result is essentially the same as if we use, add nominal WACC and deducted inflation times the valuation?

MR HOUSTON: That's correct.

MR SELL: So given that, you know, all these methods are intended to provide financial capital maintenance, and I think we accept that they do, then the issue seems to come down to more subtle factors to do with the smoothness of, if you like, indexing using different indices.

I guess I'm interested in the conclusion that you came to in your presentation just now, that CPI would give you a smoother result than indexing using some sort of capital cost index, and not just because it seems to be different from your submission. I am not trying to, sort of, drive a wedge in there but really just talk about this from a technical point of view.

MR HOUSTON: Sure.

MR SELL: Can you explain to us why it is you believe that you would get a smoother result from using CPI, as opposed to some sort of specific capital cost index?

MR HOUSTON: Well, if you used a capital cost index to index the asset values, then you have to figure out how you're going to address the issue of inflation. Are you going to have it - is that capital cost index going to be net of inflation; or is inflation going to be dealt with in the WACC?

So, we'd assume that under the capital cost indexation, which would be option 2 in this table, that genuine operation would be still reported or still - you'd be measuring against a WACC that included inflation.

So, in that environment, you have - let's just assume for the moment that the capital costs were to rise precisely in line with inflation, then you'd have - and even if they were 1% more or 1% less, you've still got the question of needing to net out the revaluation in order to prevent that double counting. And then periodically you have to revisit the capital costs, or whatever index you use, to see whether that actually relates to the actual

costs that are experienced.

It's that point that I think you will see some potential lumpiness in the index, lumpiness sorry in the reported ROIs, the revaluations, as the revaluations are flowed through into the income statement.

MR SELL: And your reason for saying that is because the rate of which the capital cost would have inflated in the meantime, you are expecting that that would be different from the inflation rate?

MR HOUSTON: It's got to be expected that will be different, although you can speculate as to whether it will be differently higher or differently lower, but it will inevitably be different.

MR SELL: Yeah. I guess what I thought I read into your original submission was the suggestion that if a capital cost index was used, then that would be - then you would expect there to be less of a discrepancy when you come to do the five yearly ODV recess? And that argument seemed to have some merit.

MR HOUSTON: Well, that's true but that's in the context where you have - where you are using a nominal WACC. The suggestion that you would use a CPI index for the asset value I think is made with the assumption that you will be using a real WACC. So, that's the distinction between the two.

At the end of the day, this is an empirical issue which we haven't given exhaustive thought to and it may be if sufficient attention was given to it, it may be that one or other combination could be shown to smooth over time, but our expectation is that I think the combination we would think is appropriate to choose is the one that was put in the submission, which has been acknowledged that we're suggesting may be another combination which may be even better. The one in the submission was the nominal

WACC as you currently have and the capital cost inflation, which is for the asset value.

Now, probably the assumption behind that is that over the very long-term capital cost inflation runs behind the CPI, even though I think many people would say in the next five or 10 years it will be different but that's probably the long-term expectation.

The alternative possibility is to index by the CPI and not include the CPI in the WACC and then just have the catch up or slow down, or whatever it turns out to be, for what essentially is the difference between capital costs and the CPI every five years.

MR SELL: So just to clarify, if the Commission was to propose a regime where it used a nominal WACC and it revalued using some sort of capital cost index, let's not worry too much for now exactly how that's specified, but let's assume that the objective of that index was to more or less replicate the way in which replacement cost under an ODV regime would eventually be set, would you have any difficulty with that?

MR HOUSTON: No. That's what we put forward in the submission as our preferred position. What we're simply flagging now is another possibility may be to use, rather than a nominal WACC, a real WACC, and therefore to substitute the index of the asset value from a capital cost index to the CPI.

We think, but we haven't done any detailed analysis of that, it may well be smoother but we accept that that involves changing and that's why we suggested it.

But we haven't done any detailed analysis to support that. It's just a hunch, I guess, that we have.

MR SELL: And that is an issue that's been debated amongst regulators, just so I can note this for the Commission, it has been debated amongst regulators over here too and both

approaches are in play at the moment over here in different regulatory regimes.

MR HOUSTON: I am not aware of any regulators that are indexing ODV valuations by capital price indices in Australia.

MR SELL: I guess the distinction I am making is between those that are using an - explicitly using a real WACC concept and those that are using a nominal WACC and they are subtracting revaluation.

MR HOUSTON: Sure, that's exactly right. Just to clarify that, my recollection is that the ACCC in energy regulation, which is electricity transmission in particular, distinguishes itself by using a nominal WACC framework and I think all of the stage regulators, as far as I recall, use a real WACC but it's acknowledged that they are equivalent providing all the right adjustments are made.

MR SELL: I think if you can, it would be helpful to the Commission if you can provide any empirical evidence around the smoothness or otherwise of the approaches in your cross-submission.

MR HOUSTON: Sure. I am sure we can take a look at that.

MR SELL: Otherwise, that's perhaps all the questions I had on the valuation. My other questions are on one or two aspects of information disclosure.

The first one is on ACAM and I'm afraid I wasn't able to hear very clearly some of the questioning that I think came from Commissioner Bates on this, so excuse me if it's been covered already.

But just to clarify, I think some readers of the Commission's discussion paper perhaps interpreted the discussion around ACAM as suggesting that ACAM itself could be dispensed with. You know, while it was only a discussion paper and I guess if everything is potentially up for grabs, I think it's fair to say that we were intending to try and float the idea that more prescription

was needed in ACAM rather than throwing that out a completely new methodology.

But just on that, and this is probably better to take on notice for cross-submissions, in Orion's submission on ACAM, I think we understood the general principles that were being put across and the discussion around that, but the Commission in its discussion paper noted what are some quite difficult issues, and you have alluded to some of those today around the sharing of synergy benefits between potentially two regulator businesses and also between a regulator business and an unregulated business, and those are difficult issues, as I think you've acknowledged today.

I think it would be very helpful if in your cross-submission you were able to just provide us with your views on those issues in a little more detail than is in the original submission. Do you think that might be possible?

MR HOUSTON: Yeah, I'm sure it is.

MR SUTTON: Yes.

MR SELL: Okay. In that case, I won't go into that any further now.

The next question I had is around disaggregation and, again, maybe the point that was picked up from people reading the submission might have been an implication that the Commission might be wanting the entire information disclosure set disaggregated by region and by customer group, or whatever, in some quite detailed ways. I think we would acknowledge the impracticality of doing that and it probably wouldn't even be particularly useful, even if it was practical, but I think what would be useful would be to hear from you, either now and/or in cross-submission, if you would just think along the lines of certain information being disclosed on a disaggregated

basis.

I think earlier in the Conference, and this is going back a few weeks now of course, we did hear some submissions about disaggregating quality information and how it's feasible to disaggregate that right down to the feeder level. Now, whether it's actually useful to interpret it at the feeder issue is another issue but at least if it's disclosed in that way, statistical analysis is possible, if that makes it more understandable. So, that could be one example of disaggregated information.

I think another possible way that occurs to me in thinking about disaggregated information is where there are different networks which may be under common ownership but where different pricing regimes are being imposed in those different networks, and maybe it is valid to have some information disclosed on that disaggregated basis and so on.

I don't know if you have any comments about that now or if you would just like to provide that in cross-submission.

MR ROSS: We do have some comments about the disaggregation of reliability information, and in fact if we could just hop to slide 31 please, Greg.

We do support the idea that it's useful to have reliability performance split out further than over a whole network and the key driver of our thinking is that we consider that consumer density is the key parameter which should qualify where we disclose the reliability information.

In this slide that we have here, and in terms of our submission, we submit that it would be useful to submit reliability performance by grid exit point. We don't think that it's very useful to submit by feeder.

In Orion's case we would have more than 1,000 feeders

and you just have pages and pages of numbers which would be of little use. But if you bring it down to a compromise of grid exit points where we have 14 grid exit points, we would agree that that would be - it would then provide a basis for comparison using a key parameter.

Orion already publishes its reliability performance between urban and rural. We recognised a long time ago that that was a key difference.

MR SUTTON: In fact, on top of that, we also publish information about where our ten worst feeders are as well, so we can say which customers are getting the poorer service. We do that voluntarily at the moment as well.

MR SELL: Okay. Well look, that's useful and that's the sort of lines that we would quite like you to think along perhaps, not just in relation to quality but perhaps also in relation to some of the other information that's disclosed.

MR ROSS: Yep.

MR SELL: We really just want to break into this circularity where the Commission could potentially say, well, here's all the information, here is the way we would like a whole bunch of information disclosed, and simply get feedback it's not practical.

On the other hand, you might say it's practical to disclose a whole lot of information in a certain way and the Commission might say that's really of no great use to us.

If you were able to think both around what's practical and also potentially of some value to stakeholders, to the Commission and to your consumers as stakeholders and submit on that, I think that would be very useful.

CHAIR: Paul, I think we've got a bit more presentation to go through, so I might take the rest of that from Orion and

then we will see if there's any time left for further questions, but if we can keep the summary as brief as you can, that would be helpful. Don't feel you have to go over points we've already covered going through the remainder of the material.

MR SUTTON: Neville, are there any points you think we want to -

MR ROSS: In the presentation slides we talk quite a lot about key performance indicators and the need to keep them in mind when assessing the business.

If we could just - I think we have already covered quite a lot of the material in those slides.

If we just hop to the last one, that's slide 32, we do agree with the suggestion that workshops should be held.

We also consider that there should be workshops on non-financial information disclosure specification.

However, we do consider that the process and the timetable are rather too ambitious, particularly if the Commission was to go ahead with the IHC alternative.

I think that's -

MR SUTTON: I think the other point we'd like to make is I think sometimes people talk about the amount we use the information disclosure, the information brought out by other companies. We often actually find other companies' information disclosure perhaps not as useful as perhaps some people might think. We tend to only do the comparisons at the highest level. We don't try and compare information disclosure at the lower level, things like direct costs versus - my direct costs versus someone else's direct costs. We tend to combine the two because we find the information generally isn't meaningful. People haven't put the same costs in the same boxes as we might have.

So, I wouldn't overemphasise how useful we find some of the information disclosure. In fact, if you do it in even more detail, I am not sure we're going to find that a whole lot more useful.

Shall we just go through some of the questions, the Commission's questions. We might skip through these. The first one is one that, Mark, you were going to, which was around the what was the purpose of the information disclosure. I think we've given that a good -

CHAIR: Yes.

MR SUTTON: The second one, which is reconcile the regulatory or statutory accounts. Graeme, is there anything you want to emphasise here?

MR WILSON: I guess one of our comments here is there is, we believe, no need for full GAAP compliance financial statements to be prepared. We see that they are a very useful format for presenting information but we don't necessarily see that it needs to form part of the regime.

We are certainly more than happy to work through and come up with GAAP compliant financial disclosures. For example, determining profit, determining revenue information. We don't actually see the full financial statements are necessarily a requirement. We've found them not to be particularly beneficial in our own comparators with the lines companies, for example.

MR TAYLOR: How would you determine profit without them?

MR WILSON: You still would need to be work through that process with an auditor and that's certainly information that could be disclosed without it necessarily being part of the full set of financial statements.

For example, is there a need for a statement of cashflows, those sorts of things. We would argue there is not, it doesn't contribute a great deal to the information disclosures.

MR TAYLOR: I was specifically referencing your comment about being happy to provide profit, and I was wondering how you provide detailed profit without going through the debits and the credits, as it were.

MR WILSON: We certainly have to work through that process very clearly in determining the profit that has been earned by that line business and that requires us to analyse the full set of financial statements that we prepare for statutory purposes.

However, it could well be that instead of coming up with the multi page, I think there are approximately 20 pages of financial disclosures which we gazette as part of a total gazette package of 30 pages, we would say perhaps more appropriately it might be to arrive at the smaller selected set of disclosures which would include such things as net surplus but it needn't necessarily be in the format of the full set of financial statements which are GAAP compliant, especially at the moment in an environment where GAAP is changing as information financial reporting standards are adopted.

MR TAYLOR: I understand what you said.

MR SUTTON: Question 3 is really more around the same issue we've already been talking about just now. We can move on from that.

Question 4, I think we've talked at length about that issue. I don't think we need to cover that any further.

The tax issue, I think Greg has had a pretty good go around that as well, unless you want to discuss that further?

MR TAYLOR: I don't.

MR SUTTON: Disaggregation, I think we've talked quite a lot about that as well. I think they're really seen as page markers now.

Question 7, I guess this is really just the point I

was also making before around the fact we don't necessarily use all that information. The level of disaggregation that is put out there at the moment, we don't necessarily use all that information at the moment in terms of how we look at this information.

Question 8 was really around projected financial information. I guess, Graeme, did you want to - shall we talk about that briefly, Commissioners?

CHAIR: Yes, I think that would be helpful.

MR WILSON: I think our experience in recent years has been that even with an asset management plan that is focused a few years ahead, that customer priorities and changes in such things as irrigation and dairying have certainly caused a number of differences to occur, even in the very, very short-term, between where we thought we were going to be spending money and where we have actually spent that money.

We certainly already make reasonably extensive disclosures of our future performance as far as asset management plan, as far as our plan to capital and maintenance over the next 10 or so year period.

From an accounting perspective, we believe though that if we are going to be coming up with detailed forecasts, which are then in turn subjected to detailed reconciliation post event, firstly we aren't confident we will be able to get those audited at all and we would also be heavily caveating any of the forecast information put out in the public domain in case things were to change.

We also recognise at the moment there is probably little ability for us to markedly change our profit moving forward because of the existing threshold regime that's in place.

And, again, to significantly move those profits up or down during that timeframe.

There is certainly a prospect of some commercial sensitivity, especially if mergers or acquisitions are envisaged. Yet again, I suspect our approach to that would be to caveat any forecast information by specifically excluding the benefit of any of those mergers or acquisitions.

CHAIR: I just wonder if we could take this a little further because I understand in Australia lines businesses do provide five year projections to the regulator and it might be helpful for us to hear a little bit about how that works in Australia. Are these issues of concern to Orion, issues that have come up in the Australian context in terms of the practicalities and difficulties of providing it?

And then second of all, I perhaps ask Mr Houston about his view on whether it has any merit in the context of the thresholds regime such as what we have?

MR HOUSTON: I think the draft decision paper mischaracterises a little the role of forecast in other regulatory regimes.

As far as I am aware, the principle, if not the only time that regulator businesses in the lines industry and other industries are asked to provide financial or business plan and financial forecasts to regulators is at the time of essentially a building block based reset and offer price control. Clearly that information is fundamental to that process and after the event the reconciliation of what was provided at the time with what it turns out to be is also of great interest when you come to do the next reset and so on.

But the situation here is quite different and if the intention was to reset the thresholds using a building block approach, then, sure, you would need forecasts but unless and until that time arises, it seems to me that forecasts have little or really no role under the regime

as it's currently in place.

There's no jurisdiction of which I am aware, where sort of rolling updated five year business plan forecasts are required to be developed or submitted to a regulator, and I think that would be fraught with the kind of problems that have been discussed here.

Where they are submitted on a periodic basis is not with reference to routine disclosure of regulatory accounts but it's a periodic process, it is a full price review, and interestingly, you know, that information is generally never asked for by reference to some legal requirement. It's a price review and you don't have to submit it but, you know, people generally find it's in their interests to tell the regulator what it is they think they're going to spend and need in the way of income and expenditure.

So, I think the parallel in other jurisdictions is not quite appropriate for the arrangements that you have in place here at the moment.

MR SELL: Could I just interject with a comment on that?

CHAIR: Sure.

MR SELL: I think to clarify, we've heard from other submitters the horror stories of the wall of wire, this kind of thing, and certainly we're conscious that there can be a need for the Commission and for other stakeholders to understand what's coming up. We can't always run a regulatory regime looking squarely in the rear view mirror.

And so, in some respects we are really just trying to help the situation here by providing a mechanism for that.

Now, there is the asset management planning mechanism already out there and we are not necessarily suggesting something totally new and something that's totally in parallel that duplicates that asset management planning

process, but I think what we would be interested in would be some further comments just thinking about how the perspective financial requirements and expenditure requirements of the business are going to profile going forward, and that doesn't necessarily have to mean rolling annual updates.

I think we would be open to the suggestion that maybe these could just be done once every five years at the time of the threshold reset, you know, that is a useful suggestion to make, I think.

It could also just involve largely, or even just completely, tightening up the requirements in the asset management plan because I think we've also had some submissions along the lines that the asset management planning requirements leave a lot to interpretation and there could be some value in just tightening that up, so that it's possible to come back ex-post and compare actuals with forecast.

So, just thinking along some of those lines, it, again, might be useful to get a little more commentary back from you in cross-submission.

MR SUTTON: Yeah, I think we acknowledge that point, that in fact if the costs are increasing significantly going into the future, the sooner we're signalling those costs to stakeholders the better.

So that, regulatory regimes and stakeholders expectations can be better met and I guess we don't necessarily call it the wall of wire, but we recently did an exercise to look at our asset management plan to compare what our forecast for costs going forward were for the next 10 years compared to what we think our forecast was going forward, what we thought they were going to be in 2001, and we find that our overall costs, that's maintenance, replacement, major projects, all the cash

costs, are going to go up about 50%, even taking inflation into account, going forward now compared to what we thought they were going to be going forward five years ago.

There's a whole range of things, some of it are some of the issues other people have talked about, in terms of assets installed needing replacement. We also have issues around a number of our assets are at their half life and requiring more maintenance than we expected and that drives us almost to wonder whether in our asset management plan we should have a line in there for transparent contingency, stuff we don't know what's going to come but we wonder if it's going to come, and put that in the forecast. We will think more about this in the cross-submission.

CHAIR: Okay. I think we're to the concluding remarks, is that right?

MR SUTTON: Yes. I think we've had a pretty good go over - I think Mark had a good discussion around the legal framework, making sure we do actually keep it - that it does end up meeting your needs in terms of the legislation.

In terms of asset valuation, I wasn't going to add a whole lot. Perhaps just emphasise if we're going to use ODV we have to make sure it is an ODV that does reflect the averagely effective new entrant. It isn't just the guy that is on fine days using green trucks on fine fields.

I think we've had a pretty good discussion around the indexation issue. In terms of the information disclosure, I think a lot of that was really around making sure - well, really acknowledging the information disclosure and threshold regime are complementary, they work side by side and support each other.

I guess we've talked a bit about the independent audit but we actually have had, you know, perhaps it reflects our own experience with our auditors. We think they really do retain a useful purpose and we either have faith in the auditors or we don't and at the moment as a manager I see they do challenge, probe and I guess I don't want to go through that process too many times.

CHAIR: Okay. I will just see if there are any burning questions that anyone has left for Orion. (Commission members indicate they have no questions).

CHAIR: Paul, did you have any remaining questions that you wanted to pick up?

MR SELL: No, look, I think all the important ones have been covered, thank you very much.

CHAIR: All right. Thank you very much, Mr Sutton, for the written submissions, also the oral submissions. We are, as always, grateful that you have brought your experts and that you, yourself, has personally come with your management team, so we are appreciative of the evidence that you have put before us.

I now propose to break until 2.15. I think the transcriber is going to need a bit of a break, I just want to, if it's agreeable with The Lines Company, who will be appearing when we return -

MR ANDERSON: 2.10 perhaps?

CHAIR: 2.10, that's fine. We will take 2.10. Thank you once again.

Conference adjourned from 1.35 p.m. until 2.10 p.m.

CHAIR: All right. I'd like to resume this afternoon's session and I'd like now to welcome The Lines Company and, again, thank you very much for helping us to reschedule today, both for today but also from the last attempt at the

conference, and we would ask that you introduce yourself for the record and you begin your summary of your submission when you're ready.

PRESENTATION ON BEHALF OF THE LINES COMPANY LIMITED

MR ANDERSON: I am John Anderson, CEO of The Lines Company, with me is Brent Norriss our Engineering Manager. Brent has worked for a number of power companies. He has a great deal of experience in what differentiates lines companies and also more recently a lot of experience in distributor generation.

Two issues which we wish to focus on is, one, the requirement on the disclosure to assess relative performance of lines companies; and, two, our concern with the tax treatment issues.

On relative performance, section 57V requires the Commission to publish an analysis of disclosed information for the purpose of promoting greater understanding of the relative performance.

We would suggest that by imposing that duty upon the Commission, there is as much danger in actually disclosing something which incorrectly assesses somebody's performance as being inadequate, as it is in being adequate. We find with the C2 factors that that is arising.

The current C2 factors reflect a combination of low density and load factor, not performance. We suggest this may be due to an attempt to override the ODV figures, and we talk about that in a minute, and insufficient data on which to analyse OPEX performance.

In support of our contention, we have this graph. This is not our work. The person who has put this together has plotted load factor density and connection density. The theory being that if you're below the dotted line there where you have a load connection density and a load factor, there is a very strong propensity for the Commission to assign you a factor of plus 1 and say you are insufficient.

If you are in the middle, there has been a strong propensity for the Commission to assign a factor of zero and therefore judge you moderately efficient.

If you are above the line, there then is a strong propensity for the Commission to judge your performance as very efficient and award an X factor of negative 1.

CHAIR: What is the sense for this?

MR ANDERSON: The economist who has put this together, who at this stage I am not able to name although looking at the graph the client is probably obvious, has simply plotted the X factors against the disclosed load factors, connection density by connections per kilometre, capacity factor by megawatt hours divided by peak demand within the Commission's own disclosures.

As can be seen from that graph, all but four of the assigned X factors can be explained simply because of the combination of load factor density and connection density.

So, what you end up with, which is a C factor, which simply plots load factor and connection density and not performance at all.

The Lines Company, where that little blue dot way down the bottom in the left-hand corner, in theory, as I stated to the commission last time I turned up in October 2003, given relative costs, they might have expected to actually end up with a plus 1 factor. It was only because we were holding costs down to a state which was totally and utterly not able to be continued, that we actually ended up with a zero factor.

If you'd like to judge the relative difference between where we were and where the line is, that would suggest that for the five years leading up to those factors that were based on, we were probably the most efficient company as far as OPEX expenditure goes in New Zealand.

Since then we have dramatically increased our expenditure mainly in tree maintenance but that is a factor we will also get on to.

We are suggesting that, in fact, that correlation was due to two factors. One, there was an attempt to override ODV figures. In other words, the formula that was used to collate the C2 tried to assess an optimum CAPEX level, an optimum investment level.

Irrespective of the number of factors, and you've actually got an extremely good list from Orion, which actually drives different levels of investment, most of which are to do with customers.

The second we would suggest is that currently there's insufficient data being disclosed on which to analyse OPEX performance.

We believe very strongly that CAPEX efficiency is already part of the ODV process.

Inefficient investment is optimised out. There is an engineering assessment weighing all factors.

We would suggest that if it is believed there are more incentives to be needed on CAPEX performance, then that should be part of the ODV or asset management plan disclosure. We have, in the submission that we put forward to you, raised a number of concerns we have with the suggestion within the discussion paper that transformly utilisation is actually an adequate measure of investment.

There's a number of factors which would suggest it's not, urban versus rural, customer requirements, the customer may want double the level of investment in transformers simply because he might want security.

There's the whole issue of who owns transformers, whether you factor out customer owned transformers or not.

And of course there's distributor generation. Our

network is full of transformers now for distributor generators. How do you assess those? They do nothing whatsoever to actually affect the network peak.

All those factors, however, are actually weighed up when an engineer audits its ODV and we don't - we suggest that the whole idea of actually doing a second guess of what your ODV figures should be through some sort of formula, if you want to produce those formula, fine, but you should actually be asking the engineers within the ODV report, the engineering auditor to actually comment upon them.

If the form was suggest transformers should be worth X amount but the ODV suggests it should be Y amount, that should be subject to a comment in the ODV report. It shouldn't be the subject of a second factor which suggests that this company is relatively inefficient.

OPEX performance. We've gone through our list of things which affect performance and Orion's list of things which affect performance and separated out those which we think actually affect OPEX performance from those which we actually think affect investment.

Obviously line length and customer numbers, that was covered by Orion.

Asset age, nobody seems to cover asset age, although Orion on its way out mentioned that because its assets are getting more than the halfway point that its maintenance cost is now going up. It seems to us that is a reasonable corollary, the older the asset is the higher the maintenance.

That can be measured by the ratio of ODV to replacement cost.

We have been involved in a process a couple of months ago by PowerNet who seem to be going through all the networks in New Zealand trying to get that ratio, it

wouldn't hurt any of the companies to disclose it. That information would then be available to the Commission for analysis.

Trees. Anecdotally it would appear that we spend the same amount on tree maintenance as Orion does. Orion has more than 10 times the customer base that we do. However, because it's not as geographically disbursed as we do, and because it is in an area which was settled reasonably on and is part of New Zealand's natural process, it doesn't actually hold a large degree of native trees. We do.

They produce its figures out of the Commission report in Queensland and would suggest that up to 80% of your outages are caused by vegetation problems.

Our expenditure in trees has grown dramatically over the past five years, to the extent that trees now amount to approximately 20% of our total OPEX expenditure. I am sure with Orion it would be probably lucky to scratch 1% or 2%. That is a huge variable and I think those sorts of figures are needed. If nothing else, we would suggest that perhaps expenditure on trees should be deemed to be efficient.

Ruggedness of the country. Obviously the more rugged the country the harder it is to access lines, the longer it is that outages will be, the higher the cost. This also influences customer problems. We find that customers who live in rugged country are inclined to give us - we have to put more engineering resources into helping them with their problems than we do with customers who are on the plain.

Now again, it is possible, even within the current, to easily disclose a measure of ruggedness by simply looking at the numbers of kilometres of line in an ODV report, under which the ruggedness multiplier is applied versus the total kilometres of line.

If nothing else, again, that would give a factor which could be actually added in at relatively little cost.

Climate. That's obviously a factor. Lightning storms, snow storms, propensity to high winds, all fact maintenance costs.

Distance from contractor's depots. This affects not only travelling cost but the ability in a time where we're all short of staff to actually attract staff. It's much harder to attract staff in Te Kuiti than it is into Hamilton. There's a premium which begins to be attached to that.

MR TAYLOR: Living in Te Kuiti?

MR ANDERSON: Even worse living in Taumarunui. You can ask yourself what sort of premium you would want to add to your current salary for that to be attractive.

The last thing we have is connected generation to size and output. One of the things which we find, which is absent in the total work of the Commission to date, is the fact that generation, distributors generation as a network cost. We have lines which are now of a size solely because of the connected generation attached to them, not because of the load.

The generators tend, if they are either wind or hydro, to actually situate themselves in areas, apart from the hills of Wellington, where there is actually very little load. So, you're not actually matching the generation against the load. You actually have to ship it to where the load is. That requires an investment cost. It requires a maintenance cost and requires a substantial engineering cost in actually dealing with those connection problems.

I will hand over to Brent so he can talk further on those influences.

MR NORRISS: Thanks, John. Just briefly covering some of those and following up from where I come from. I am an engineer who has been in the industry for 35 years and worked for power companies in both islands in various roles and I find it difficult, as I go through all this in the real hands on part of it, to watching people trying to measure power companies on a spreadsheet. That is pretty impossible, like it is to measure various farms for a farmer comparing farms.

There's so many things that feed into that, you have geography, history, trees and, more latterly, generation and that's an area I'm quite happy to have an endless debate with any technical expert on. So many performance indicators being brought into fact today don't really consider these use costs associated with distributor generation.

The Lines Company has two engineers, that's who we employ and one of those engineers spends all his time sorting out issues with distributor generators, that's the historic plant we have connected which consists of 22 machines.

So, it's a huge area and a huge area of cost and there's a whole lot of areas that people haven't yet understood, and that is things like power factors at grid exit points, it goes on and on and on. So, yeah, there's a lot of work to be done there.

The other point is as an engineer in the industry, the more time we spend putting this information together and sorting this information, the less time we have for innovation and that really, you know, for a company such as The Lines Company in the King Country, reduces the things we can do.

We can do lots of things to try and reduce costs. For example, we have started tree cutting from a

helicopter. Does anyone want their roses trimmed? There mightn't be anything else left in your garden but we will give them a stir up.

Those sort of innovative things is where we would like to be going. Every hour reporting is not another hour coming up with some way of keeping those costs down. Our forerunners invented earth return and ran that through the company, we have to fix it up and we have to find a lot more innovative ways of doing that and they are there, the solutions are available and it's just a matter of taking the industry forward and finding them.

MR ANDERSON: So, if we look at relative performance, we believe the Commission is to seriously analyse relative performance as it has an obligation under 57V. It needs good data on the factors that actually influence performance.

What we've tried to do is to give you a list. Wherever possible we've given you ways of measuring that which will have very little cost to impact upon the individual line companies. We suggest we may be able to draw on things like density of trees, be able to get some sort of measure out of that.

Moving on to our second concern, tax, we have attached a number of spreadsheets which I am not going to go over for the purpose of this presentation.

We acknowledge that your revenue formula of adding back the revaluation, that somewhere along the line there needs to be an adjustment for the fact that the depreciation on that revaluation adjustment is not deductible for tax purposes because unless that adjustment is made, then it certainly doesn't add back to any NPV on the investment.

We would suggest that can be done either by adjusting tax to tax paid, which appears to be the Commission's

preferred approach out of the discussion paper, or simply adjusting the revaluation adjustment added back.

We suggested in the original paper that we put forward, that in fact it could be adjusted by 1 minus the applicable tax factor. That, in fact, from further playing around with spreadsheets, would appear not to be the case because there is obviously some sort of time movement in there but we are not economists. You have a lot of economists reporting to you. I am sure they could actually come up with an appropriate figure to adjust that revaluation figure back so it was less than 1, a figure of less than 1, in which case the tax implications are weighed up front.

The difficulties with actual tax paid are it overrides the government incentive signals through the tax system. The government actually wishes to signal that it pushes us to make investment in new assets by giving us an increased rate of deductibility, then for the Commission to actually come and look at the actual tax paid and say that it will take that into account in setting our rate of return, means that that incentive signal is completely and utterly gone.

Has a perverse effect on acquisitions. I gave a copy of that in the submission factor. It would appear that if a trust owned company who has held its assets for a relatively long time, as we have, were to sell to our next door neighbour, then our next door neighbour would have to lower its prices, inasmuch as the assets it would be acquiring would be tax deductible for it, but of course there's a huge chunk of the current asset value which is not tax deductible for us.

That would appear to be a perverse outcome, whereby we simply, because we've held assets for a long period of time, can actually charge a higher price than a future

acquirer.

Penalises line renewals. In many cases the expenditure which we're actually spending on poles currently is fully tax deductible for tax.

It shows in one of these spreadsheets here that because it's fully deductible for tax it's not a maintenance item as far as you guys are concerned because it does adjust the ODV value, so you're spending on CAPEX deducting for tax. That will lower the tax paid, that will increase the return, so therefore you're seeking a price lowering at the same time as expenditure is going up.

It's a totally perverse outcome and is a very strong signal not to actually spend on line renewals.

Trust owned companies, one, it lowers our borrowing ability. This is addressing the current situation where it appears that the rebates that we pay back to our customers, the discretionary rebates, are in fact the tax on those that have been taken into account when assessing our rate of return.

I've given you a spreadsheet on that, which is the last spreadsheet. Like most organisations, the banks look at our uncommitted cash basis, and assuming that depreciation is equal to what you'd want to reinvest back into the network, then if we were a dividend paying company, or if the tax effect wasn't taken into account, then we would have a borrowing ability in that example of \$32,000 or \$32 million or whatever.

The Commission's approach by actually pushing the nominal tax down by taking into effect the distribution would mean that we would be exceeding the threshold. Our only response is to either lower pricings or to commit to discount. The moment we commit to discount in our pricing structure, that payment of discount is no longer

discretionary and the banks of course will lower our ebit ratio accordingly. Our commitment to the banks with the ratio is to take on discretionary discount above the line.

That immediately lowers our borrowing ability by up to a third.

Obviously that varies upon the size of the distribution.

The other perverse incentive that it actually does give is not to distribute the rebates at all and to invest them into a totally non-associated business. We gather that there is some concern from one of the Commissioners, who unfortunately is not present at present, about the fact that lines companies are actually doing that. But when you are artificially lowering our return within our core business by treating the discounts that we give for calculation of the return, then it provides us with a very strong signal to actually invest in non-regulated businesses.

Finally, if it was actually converted through to price increases, either by way of lowering price or by way of committing discount, I then would suggest that completely distorts customers' investment decisions. In effect, what you're saying is the opportunity cost of resources consumed by a dividend paying company is higher than the opportunity cost of that from a trust owned company, which doesn't seem to make any sense at all.

So, therefore, you're actually encouraging customers in trust owned companies to make decisions on which they wouldn't make if they were owned by a dividend paying company.

The last point that we've got on there is the combination of them means that what you get is existing customers must actually pay for asset upgrades. Once you are owing your borrowing ability, then the only people

that you can actually turn to are your existing customers. How do they pay?

One, you have the perverse situation by way of the less discount that we pay the customers, the higher we can charge their price. In effect, because we have a lower borrowing ability, the way to maximise our capital is, in fact, to lower the discount and to increase price. That funds for assets but unfortunately within customer owned trusts, trusts shareholder beneficiaries haven't got the power to capture that value.

If you are a shareholder in a dividend paying company and the company decides not to pay a dividend, then your expectation is by reinvesting that money back into the company, that the company will grow in value and that your shares will grow in value.

So, by forsaking the dividend, you can actually sell the share. Either way you as an individual captures that benefit.

If you are a beneficiary in a customer trust owned company and the company cuts the discount back in order to fund capital works, you have got no way at all, unless the company itself is totally sold, of actually capturing that value. You don't own the shares. You don't actually own a slice of the equity.

So, therefore, you have one generation of customers forsaking a cashflow for the sake of a future generation, and that doesn't seem to us to be an appropriate economic signal.

In summary, we would suggest/recommend that the disclosure with regard to CAPEX efficiency should be part of the ODV process and should be reported on within the ODV report and the asset management report, and that formula should not be invented simply to second guess what the ODV value should be.

That is subject to an engineering audit. I have heard comments about the accuracy of auditors and if a further rigorous approach to the engineering of the ODV audit is needed, then that's fine but that is the appropriate place to do it, not in a totally separate formula.

We are also recommending that disclosures relating to OPEX efficiency must be robust enough to provide the Commission with the ability to effectively report on relative performance.

Some of the difficulties that we've got, if we go back to this slide, is that you've actually got companies who are sitting in exactly the right price band versus C factor. One of them is claiming it is the most efficient company in New Zealand because that's the way the Commission has assessed its C factor. There's absolutely no pressure on that company to improve performance.

Where it is, is it's sitting right in the average. There's nothing special about that organisation. It's solely ranked because of its peculiar combination of load factor and connection density.

So, there's a danger in publishing a report on relative performance which doesn't accurately assess relative performance, both in the fact that those companies who can sit and say you didn't take this factor and this factor and this factor into consideration, will sit there and not do anything to improve performance because they believe that they've found excuses. That happens a lot now.

When you look at high level analysis, it's very easy to say these factors weren't taken into account, therefore this doesn't really apply to us.

On the one hand, if there's any room left for the ability to excuse, they will not drive performance; and

secondly, where you've actually inadequately assessed somebody's performance as being good when it's not, you would have moved all drivers for that individual company to improve.

So, the nearer you can get to fully putting in all drivers' performance, the better.

Finally, we would agree with Orion, that there should be a synthetic tax rate and we would suggest that rather than adjusting tax for the non-deductibility effect of the revaluations, that a factor should be applied to the revaluation added back which takes in that non-deductibility component.

Thank you for listening to us.

CHAIR: Can I just clarify, were you part of the PWC work this time?

MR ANDERSON: Yes, we were.

CHAIR: I take it otherwise you agree with their recommendations to us?

MR ANDERSON: We support the general gist. We believe that much of what's disclosed currently is irrelevant, especially if you look at the breakdown of costs and the various components that were put, it would seem to be no purpose, and from the point of view of trying to put the things together, we can understand why there would be gross variations from one company to another.

However, we believe that a focus by the Commission on things which actually drive performance could be done at relatively little cost.

CHAIR: In your submission you talk about a business being double penalised, and this was in the area of productive efficiency incentives, because of the way we treat asset optimisation and I wondered if you could take us through why you think that's the case because we're not clear on why that would be the case. If assets are optimised out

then they wouldn't be in the dominator, so why you would be double penalised? We're not sure.

MR ANDERSON: If you look at things, for example, a classic one would be what's in the discussion paper, transformers. If you're looking at transformer efficiency, then the sites and the number of transformers that you've got is in the disclosed statistics.

Now, in an ODV, they've gone through and actually looked at those individual transformers and said where it's inefficient they've optimised it out.

But having gone through a process where you've actually got the valuation on which you can get a return, where those transformers are optimised out, you are now suggesting there should be a second formula which actually tries to second guess what the ODV formula is. There's a certain amount of second guessing in that. There's a certain amount of double penalising because the extent to which you've got any transformers which should have been optimised out, they have been optimised out. Therefore it shouldn't count against you in that second figure that you've got transformers that you shouldn't have.

What you're trying to do is either say the ODV figure is wrong, or you're saying that we will provide a disincentive for performance because you've actually invested in assets which were then optimised out under the ODV process.

Now, what we're saying is the sole penalty should be that optimisation out under the ODV process. There doesn't need to be any other penalty for the fact that you've over invested, whether it's in more transformers or bigger transformers or anything else.

Getting back, if you had faith in the ODV process, why did you have that discussion in the document about transformers and transformer sizes because they are

components one of the ODV assessments?

MR TAYLOR: Paolo, you understand these spreadsheets, do you, because I didn't pick it up in quite the way it was rattled through and I will need to have that explained to me in slow time.

MR RYAN: Can I just clarify with you, John, in terms of the line renewals, what you're actually saying is the increased expenditure on the line renewals because it is an expense of a capital nature won't appear in the PNL, so won't affect that net revenue but the tax effect will?

MR ANDERSON: Correct because it's deductible, a lot of it is deductible for tax purposes.

MR RYAN: Thank you.

MR TAYLOR: I was particularly interested in this last spreadsheet. Did you get your mind around -

MR RYAN: Yes, I haven't had the opportunity to, sort of, work through this one at this stage.

MR ANDERSON: What it's saying in the first half -

MR TAYLOR: If you've got the moving parts, if we follow it through later that's okay.

MR RYAN: Yes.

MR ANDERSON: If you have any questions, Paolo, get back to me.

MR RYAN: Okay.

CHAIR: Can I just see if Paul Sell has any questions. Is he on line? Paul, are you on the line?

MR SELL: Yes, I am. Yes, I do have a question around OPEX comparability. We've heard you talk about the difficulties of comparing OPEX between companies, and I think we'd all acknowledge it's not easy. Are you saying it's difficult or are you saying it's impossible?

MR ANDERSON: We would say it's difficult.

If you factor in things like age and things like ruggedness, which at least are two major ones which were put in there, and if you took trees out of it, then I

think at least you would start to get a figure which becomes more an assessment of where companies actually stand relative to each other.

The difficulty at present is it's been done on too high a level and about the only factor which seems to be considered is customer density and we're not too - well, we know for a fact that that's not sufficient.

MR SELL: Yes look, that's fine and I think we'd simply look forward to getting more detail, whether it's in cross-submission stage or some later stage in the Commission's process, around, you know, what type of input factors we may need to measure in order to be able to get meaningful measurements of productive efficiency.

MR ANDERSON: Yeah. We hope that we've suggested one or two in the slides which you've got.

MR SELL: Yes.

The second question I have is I'm afraid I'm still struggling to understand the point that you are making around it sounds like a kind of double jeopardy effect in relation to CAPEX efficiency.

You're talking about ODV and the fact it's an optimisation process there which we acknowledge. From my recollection of what's in the Commission's discussion paper, there's relatively little on CAPEX efficiency and really it's just talking about, you know, what information should be disclosed, rather than any sort of optimisation type adjustments to CAPEX.

But are you able to just pinpoint what parts of the discussion paper you are referring to?

MR ANDERSON: I suppose we have two concerns. One, if you go back to the CT factor - C2 factor analysis, then the relative CAPEX efficiencies seem to emerge fairly strongly within that, which is part of the difficulty, while you've ended up with something which varies simply according to

load factor and connection density.

So, in effect, you've got that double dip approach through there.

Secondly, when we actually went to the discussion paper, while it threw out a number of things looking at efficiency because they were heavily weighted by customers, it then started looking at a measure of transformer size versus system peak. And transformer investment is, again, part of CAPEX efficiency. So, I suppose we were somewhat surprised by that coming through with such a strong push in the discussion paper, hence our concern.

What we're really saying is try measuring OPEX, fine, but leave the investment efficiency to the optimisation process. If you have got concerns like transformer size, then by all means ask engineers as part of the ODV process to comment on it but don't actually try and publish it as a sign of relative efficiency.

MR SELL: Yeah, if the point you're making is you can't simply take published stats and draw simplistic conclusions from them, then that's almost self-evident and I think we would agree with that.

MR ANDERSON: It's probably a little bit more than that. The point is, why would you want to even look at a measure of our investment in transformers? You've got this complicated, very expensive, from our point of view, ODV auditing process which goes through and says what the value of your investment should be. If we over invested in anything, then it takes it out.

Why do you want then to go through another process which tries and actually gets and measures investment efficiency and assets? Shouldn't assets be just parked to one side and say, look, the ODV process deals with these. We will solely look at trying to measure relative OPEX

efficiency because if you get back to the formula of, I suppose, the regulated rate of return being your regulated return, your adjustment to the revaluation which we talked about, then the only other component to add to it is in "efficiency" OPEX. So, we believe that that's where the Commission's focus should lie on what is, in fact, an efficient level of OPEX.

MR SELL: Just noting that ODVs are only going to be done once every five years, do you see any value in disclosing, in the interim at least, what CAPEX levels are and some information which might allow interested onlookers to try and form some judgments as to whether the CAPEX is being incurred according to some sort of plan or at a reasonably efficient level?

MR ANDERSON: Yeah, no difficulty with that and I think in our submission we again said that we fully support the asset management plan process where those sort of things should be disclosed.

All we're saying is you shouldn't be reporting some other ratio which tries to second guess whether you are efficient or not. It should be obvious from the asset management plan, if people look at the age of the assets and the spend, as to what is going on.

MR SELL: Okay. So, you're saying disclosures in relation to CAPEX through the asset management plan and the remainder of the information disclosure regime should then focus on OPEX?

MR ANDERSON: Yep.

MR SELL: Is that a fair summary?

MR ANDERSON: Yes. We see over the past few years there's been a lot of effort being put in on the investment CAPEX side in the asset management plan and the ODV report. All that leaves you with is a grey area at present of OPEX.

MR SELL: Okay. Thanks for that and that is the only questions

I have.

CHAIR: Thanks Paul. Can I just ask staff if you have any questions? (No questions from staff members). Are there any final remarks you would like to make?

MR ANDERSON: The only thing I would remark on is in our original submission we did actually include a copy of the letter which we sent to the Commission back in the beginning of January 2004. That was because we were unsure in the evidence out of the Court case whether that had come to the sight of the Commissioners. There was some suggestion that it had been actually considered by Dr Gunn and was offering no further value to what the Commission had already seen.

My directors are fairly concerned over the whole issue of how the rebates are treated for tax purposes. We have, in fact, the possibility of - we have got one seaside settlement actually asking us for investment at present and dramatically upgrading supplies into an area for the benefit of holiday-home owners from out of our area. Taxation consideration is pretty important because if our rebates are actually treated as lowering our tax, then we will in all likelihood breach the threshold and our directors have no confidence that in fact we won't be asked to lower prices, therefore we will get no return from that investment at all.

If they're not, then we can at least seek a return from the holiday owners appropriate to that new level of investment.

So, currently, we've actually declared a moratorium on all new connections in that area while we grapple with that issue.

The Commission staff have a letter and I suppose we will expect a reply in due course.

CHAIR: Okay. I think those issues probably need to be handled

outside this forum.

MR ANDERSON: Certainly. All I am suggesting is the relative importance and impact it may actually have.

CHAIR: Sure. I would like to now thank The Lines Company for its participation in the PWC report and also for the submission and presentation you have given to us separate to them. We do appreciate the time that you have taken and we will give the submission, along with the others, close attention.

CLOSING REMARKS BY THE CHAIR

CHAIR: It is now for me to close the Conference. I think I will just have the closing remarks typed into the transcript.

The thing that I would like to remind parties of is that the final submissions, both in response to questions we had and written cross-submissions are due by 18 April.

Other than that, I will leave the words for the transcript. I am sure all interested parties can find them.

Finally, I would just like to thank staff for all their hard work and of course the communications staff and transcriber, thank you very much, and I will declare the Conference closed.

[Written Closing Remarks by the Chair read as follows:

"This concludes the Commerce Commission's conference held over four days on the review of the information disclosure regime and implementing valuation choice for systems fixed assets for electricity lines businesses. I would like to close this conference with the following remarks.

First, during this conference the Commission has made a number of requests for further information from the presenters. The list of further information to be supplied following the first two days of the conference held on 17 and 18 March is posted on the Commission's website. A list of further information in relation to the last two days will be posted on the Commission's website as soon as possible. I would ask affected parties to check the lists and advise the Commission if there are any matters that have been omitted or inadvertently stated.

I now ask that all requests for further information are responded to by 5.00 p.m. on Monday 18 April.

Secondly, all presenters who have provided the Commission with printed material during the conference, whether presentations or supplementary material, are asked to provide, if they have not already done so, electronic copies to the Commission within three working days so that they may be made available on the Commission's website.

Please email these copies to the Commission's "Electricity" address (i.e. electricity@comcom.govt.nz).

Finally, the Commission will consider further written submissions following the conference provided they are received by 5.00 p.m. on Monday 18 April. Any such submissions should be confined to issues or matters raised in written submissions by other parties, or raised for the first time at the conference. These submissions will also be placed on the Commission's website.

On behalf of the Commission, I would like to thank everyone for their submissions and for their participation in this conference. We have especially appreciated the access to industry and technical expertise.

I would also like to thank the Commission's expert adviser, Paul Sell, and staff, and also the transcribers and communications people who have assisted us during the conference. Finally, I would like to thank everyone for working with the Commission to keep these proceedings as efficient as possible.

Are there any final questions from any interested party?

If not, then once again to all those who have participated

in these proceedings, thank you indeed. The conference is now closed."

Conference concluded at 3.00 p.m.