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18 April 2005

Dear Sir

**Cross Submission on the Electricity Information Disclosure Discussion Paper and  
Implementing Valuation Choice Draft Decisions and Discussion Paper**

On March 18, we presented our submission to the Commerce Commission's ("the Commission") conference on Information Disclosure and Implementing Valuation Choice. This submission was prepared by PricewaterhouseCoopers on behalf of the following 21 large Electricity Lines Businesses ("ELBs"):

- Alpine Energy Limited
- Aurora Energy Limited
- Counties Power Limited
- Eastland Network Limited
- Electra Limited
- Electricity Ashburton Limited
- Electricity Invercargill Limited
- Horizon Energy Distribution Limited
- MainPower New Zealand Limited
- Marlborough Lines Limited

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- Nelson Electricity Limited
- Network Tasman Limited
- Network Waitaki Limited
- Northpower Limited
- OtagoNet Joint Venture
- Scanpower Limited
- The Lines Company Limited
- The Power Company Limited
- Top Energy Limited
- Waipa Networks Limited
- Westpower Limited.

During the conference presentation we undertook to provide the Commission with further evidence to support our submission. In addition we would like to take this opportunity to present our views on some of the issues raised by other submitters in their written submissions and at the conference.

#### **Avoided Cost Allocation Methodology and Financial Disclosures**

1. There was some discussion at the conference over the need for reconciliations of financial disclosures to statutory accounts and possibly tax statements. It is our view that reconciliations are not required to be part of the annual disclosures made by lines companies. We accept that the Commission may wish, from time to time, to request further supporting information from selected lines businesses as it undertakes its analysis and monitoring of information disclosures. This may include reconciliations if necessary. This process is similar to that currently adopted by the Commission in its examination of the

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annual Threshold Compliance Statements published by each lines business, and should be adopted by the Commission in this respect. Sufficient comfort over the compliance and accuracy of the financial disclosures is provided by the provision of regulatory rules and guidance, and the independent audit and certification by Directors. Additional disclosures by every lines business every year are not justified, would be costly to publish and would create a large volume of disclosed data.

2. It is not until the final form of the financial information to be disclosed has been determined, that the appropriate guidelines can be developed. In our 23<sup>rd</sup> February 2005 submission we noted that there is an opportunity to reduce the amount of financial information to be disclosed, and for the Commission to focus on that information which is required for the price path threshold reset, and the performance indicators the Commission wishes to use for monitoring of lines companies<sup>1</sup>. The areas where additional guidance may be justified for financial disclosures to ensure the Commission's consistency and accuracy objectives are met, is in how the Avoided Cost Allocation Methodology ("ACAM") approach is to be applied. This will necessarily require explanation of the principles underpinning ACAM, but could also be enhanced with examples relating to indirect costs, debt, working capital including cash balances, interest and taxation, should these items form part of the required financial disclosures.
3. We note the Commission's intention to undertake workshops to develop further the details of the information disclosure requirements, which as stated previously, we are happy to contribute to. We also suggest that the

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<sup>1</sup> PricewaterhouseCoopers, Submission on the Review of Information Disclosure, 23 February 2005, page 18

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Commission may wish to consider providing feedback to lines companies and their auditors if areas of inconsistency become apparent during the Commission's monitoring of information disclosures.

4. We note the discussions with Vector on day two of the conference over the level of prescription provided by GAAP and Vector's recommendation that the principles underpinning GAAP should be used for regulatory disclosure purposes<sup>2</sup>. In particular Vector proposed that the qualitative characteristics of GAAP (relevance, reliability, understandability and comparability) are just as relevant for information disclosure as they are for statutory financial statements.
5. We do not disagree with this point and believe that where possible the principles of GAAP should be applied in the regulatory regime and in particular the requirements of IFRS. We do believe however that additional prescription in limited areas (which should not be inconsistent with GAAP) may assist the Commission to meet its consistency and accuracy objectives, and avoid the disclosure of large volumes of supporting and explanatory information including reconciliations and information about non-regulated businesses. We fully support the submission of the ENA and Professor Tony Van Zijl in respect of GAAP, and their confirmation that specific rules may need to be specified around cost allocation to meet regulatory requirements, but the methodology applied should not be at variance with GAAP<sup>3</sup>. In this respect we confirm our original submission that the focus of the disclosure regime should be on electricity distribution and transmission services, not other services offered by line owners and electricity distributors<sup>4</sup>.

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<sup>2</sup> Conference Transcript Day Two, pages 242-243

<sup>3</sup> Conference Transcript Day One, page 167

<sup>4</sup> PricewaterhouseCoopers, Submission on the Review of Information Disclosure, 23 February 2005, page 12

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### **Disaggregation of Disclosed Information**

6. Customers and other users of disclosed information already have available to them line charge disclosures and disclosures of pricing methodologies to assist them in understanding how the cost of their services is derived. Thus where differential prices exist across regions within a network, the prices are publicly available. In addition, the pricing methodology disclosures provide information on how these prices are derived. There seems to be little requirement therefore for additional disaggregation of pricing information.
  
7. There has been considerable debate to date, and as a result it is anticipated that the Commission will wish to consider further, the possibility of disaggregating quality disclosures within each network. Lines business Asset Management Plans (“AMPs”) already disclose variances in security standards where these differ within networks. Further disaggregation of reliability performance statistics is however a possible useful addition to the disclosure regime. We would caution the Commission against requiring disclosures of major quantities of data in this respect, of the type proposed by Genesis Energy in their submission (for example for every ICP). We would also not support disclosures of reliability by individual feeder, as again this would result in major quantities of data, which would be difficult to interpret without further explanatory information. Should customers or retailers wish to know specific information about specific events, they should approach the relevant lines business for an explanation.

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8. What would be more useful in our view is a grouping of reliability performance by areas or regions which reflect the underlying network characteristics of load type and density (for example industrial and commercial, urban residential, rural and remote rural), which are more likely to result in fairer comparisons of reliability. For example it is reasonable for a resident in suburban New Plymouth to compare reliability with another in suburban Hastings, but not CBD Auckland or Fiordland. This is consistent with the conference presentation by WEL Networks<sup>5</sup>.
  
9. We do not however see the need for further disaggregation of other disclosed information. A focus on price and quality is consistent with the thresholds that have been set and the explanatory and disaggregated information around price and quality strengthens the ability of interested parties to understand the thresholds and the relative performance of lines businesses. Should the Commission wish to investigate a lines business further as a result of a breach of either threshold, it has the opportunity to seek out more disaggregated information if it considers the breach reflects behaviour contrary to the Purpose Statement.
  
10. Mechanisms for disaggregating other disclosure information such as financial performance measures would require a significant number of assumptions and arbitrary allocations, depending on the degree of disaggregation required and how the boundaries were to be set. The resulting information will not be meaningful, particularly some time after a merger has occurred. If the parameters for the disaggregation of financial information are set around historical network boundaries, the additional work and cost involved in

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<sup>5</sup> Conference Transcript, Day One, Pages 128-129

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generating the information will provide disincentives for such activity and reduce the efficiencies arising from mergers. We therefore do not support further disaggregation of disclosure information, other than in respect to network reliability performance.

11. We also comment in the following section on the information that is available publicly on how prices are set. These disclosures provide interested parties with information on how charges are set for different customer groups, and how lines business costs and profits are allocated between customer groups including different network regions where applicable. This supports and enhances the price and quality disclosures noted above and provides insights into how prices are set within a network.
12. At the conference there were suggestions put forward by WEL Networks that further regional disclosure by Transpower is desirable<sup>6</sup>. Current reliability disclosures prepared by distributors include Class A and Class D reliability information for:
  - the number of interruptions;
  - SAIDI;
  - SAIFI; and
  - CAIDI.
13. Class A refers to outages which occur as a result of planned interruptions originating at Transpower, and Class D refers to unplanned interruptions originating at Transpower. Thus, with the exception of the generators and customers supplied directly by Transpower, this information is publicly

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<sup>6</sup> Conference Transcript, Day One, Pages 144-145

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available by region for comparison purposes. We understand the generators and large customers also have access to interruption data relevant to their connection points, although this is not publicly available.

### **Allocative Efficiency**

14. Allocative efficiency is an important objective of the regime. That is consumers should be charged a fair price for a level of service which adequately reflects their requirements. In our 23 February 2005 submission we suggested that better use of current disclosures of terms and conditions of contracts, line charges and pricing methodologies could be made in order to help meet allocative efficiency objectives<sup>7</sup>. At the conference we were asked to expand on this point.

15. Taken together, these disclosures provide users with the information they need to determine how prices are set for every customer group, as follows:

- Requirements<sup>8</sup> 9-13 – Disclosure of prescribed terms and conditions of contracts must include:
  - a description of the goods and services to be supplied
  - the quantity of goods or services to be supplied
  - the price to be charged, timing of payments and security for payment.
  
- Requirements 25-28 – Disclosure of line charges must include:

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<sup>7</sup> PricewaterhouseCoopers, Submission on the Review of Information Disclosure, page 38

<sup>8</sup> Electricity Information Disclosure Requirements 2004, issued by the Commerce Commission, incorporating all amendments to 7 May 2004.

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- the line charges in a manner which enables individual customers to determine their total line charge
  - the transmission component
  - the previous line charge and the date that the current line charge was introduced.
- Requirements 22-23 – Disclosure of line charge methodologies must include:
    - a description of the methodology used to calculate the prices charged
    - the key components of revenue used to cover costs and profits including the cost of capital and transmission charges (including their numerical values)
    - the consumer groups or categories used when determining line charges including the rationale for the groupings, the criteria for determining the composition of each group and the statistics used for each group when applying the pricing methodology
    - how the components of revenue were allocated to each customer group to cover the costs of supply for each group, including numerical values and the rationale for the allocation process adopted
    - the method applied and rationale for determining the fixed and variable portion of charges.

16. This information is central to the allocative efficiency objectives of the regime as it provides the rationale and evidence underpinning the prices charged to consumers. Comparisons between networks are possible and to the extent that

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valid comparisons between customer groups across networks are possible, these should assist the Commission in its monitoring role.

17. In addition, we also note that there is currently an industry lead project which includes retailer representatives, well advanced in developing a standardised view on distribution pricing methodologies including cost allocations and disclosure. The Pricing Approaches Working Group will submit its recommendations to the Electricity Commission which will in due course adopt and sanction the final format agreed to.

## **Taxation**

18. At the conference, we were asked to provide further explanation about our written submission in respect of tax efficiencies. In our 23<sup>rd</sup> February 2005 submission we stated that lines businesses should not be disadvantaged from seeking to minimise the costs of doing business, including taxation<sup>9</sup>. Specifically where tax benefits accrue to consumers, lines businesses should not be penalised under the disclosure regime. Thus regulatory adjustments to taxable profits, such as by adding back customer discounts, should incorporate the tax effect of the adjustment. The tax that would have been paid if the discount had not been made should be deducted when calculating post tax profit.
19. This can be accommodated by applying a standard tax rate to taxable profits (as defined for regulatory purposes) for the purposes of information disclosure as this supports the Commission's transparency and consistency objectives. We

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<sup>9</sup> PricewaterhouseCoopers, Submission on the Review of Information Disclosure Requirements, 23 February 2005, page 26

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understand that there will be further discussion on how taxable profits are defined for regulatory purposes (for example consideration of the appropriate treatment of capital contributions) as the information disclosure review progresses. We support the views of NERA expressed at the conference in this respect, that is using any other than a standard tax rate opens up a Pandora's Box of issues that does not add value to the regime and significantly complicates its compliance and administration<sup>10</sup>. A standard rate in our view is acceptable for information disclosure purposes.

### **Audit Opinion**

20. As discussed at the conference, it is not always appropriate in a regulatory context for auditors to provide audit opinions on non financial information in the form of a "true and fair" opinion as applied in general purpose financial reporting. We have previously submitted to the Commission on this point in regards to the audit of the quality statistics contained in Threshold Compliance Statements<sup>11</sup>. The audit process is central to the Commission's regulatory regime and it is important that this provides users of the disclosed information sufficient assurance over the accuracy and consistency of disclosed information, against the regulatory requirements.

21. For non financial information in particular we suggest that the form of audit opinion contain the following elements:

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<sup>10</sup> Conference Transcript, Day Four, pages 487-488, 493-494

<sup>11</sup> PricewaterhouseCoopers, Submission on Draft Gazette Notices, 1 March 2004

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- a) That the information has been correctly compiled in accordance with the Disclosure Requirements (and other guidance that may be provided such as a Disclosure Requirements Handbook); and
- b) That the information has been calculated based on the source data provided.

We would be happy to work with the Commission further to refine its requirements in respect of auditors as the current work stream progresses. In addition, as noted previously we do not support specific regulatory requirements in respect of financial information which are inconsistent with GAAP. However, if these are introduced, the form of audit opinion for financial information will also require further consideration.

- 22. Finally, we do not support the inclusion of prospective financial information in information disclosures (other than those already provided for in AMPs). If required to be included then we would propose an audit opinion on the prospective information consistent with the form and definitions in the Securities Regulations for prospective financial information.

#### **Multi-Users of Common Assets**

- 23. To the best of our knowledge, there are currently few incidences of shared or multiple uses of electricity lines assets, although we accept that this may become more prevalent in the future. To date we have encountered this issue at one lines business, where TelstraClear uses power poles to support their overhead telecommunication circuits. They also receive electricity supply and incur electricity charges for connections of their telecommunication cabinets to the network. This lines business includes the revenue generated from the lease

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of the assets in their disclosure accounts. No adjustment to the regulatory valuation base is made. The revenues generated from the lease are not material to the business.

24. The issue of potential over or double recovery from the asset base where there are multiple users can be monitored by ensuring that all revenues derived from the electricity lines business assets are included in disclosed revenues (which is no different to the current disclosure requirements), or that the asset base is reduced in some manner to reflect the proportion utilised outside of the core monopoly business. This latter option is consistent with the District Valuation Role (“DVR”) valuations as outlined below. It is however not consistent with ACAM and therefore is not supported by this submission.
25. Utilities are required to provide utility valuations for their DVRs under the Local Government (Rating) Act 2002, which is supported by the Rating Valuation Rules issued by the Office of the Valuer-General (version 3.0 dated 9 August 2002). Underpinning this legislation is the Rating Powers Act 1988, which includes special provision for leases. As a result, guidelines prepared for DVR valuations include specific provisions for multi-utility uses of assets, where a formal lease or license arrangement exists<sup>12</sup>. In this instance, where a formal lease or license exists for a period of more than one year, valuations must be apportioned between utility operators for the purpose of the DVR. An example is provided which suggests that shared poles be allocated between utilities on the basis of the weight of the equipment supported by the poles. This requirement is subject to a 5% materiality clause.

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<sup>12</sup> DVR Discussion Document, 2001

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26. We also however note that there will be strong disincentives for lines businesses to seek out other uses for their assets, if the benefits of these are taken away by the regulator. Developing other businesses that leverage off existing distribution assets and deliver economies of scope and scale creates efficiency gains and enhances economic welfare - there is no sound economic reason why these gains should, or have to be, captured by electricity consumers in any way - the key proviso is simply that the electricity consumer should be no worse off than they would have been if these other activities didn't take place

#### **Valuation Choice**

27. There was some discussion at the conference as to the cost and benefits of maintaining a choice of valuation options for lines businesses. It appears that most distributors would be comfortable with maintaining ODV as their valuation method, particularly if it reduces the complexity and cost of the regulatory regime and enhances the comparability of regulatory information between companies. As a result we support removing the Indexed Historical Cost ("IHC") option from the regulatory regime. We do however qualify this view in that many distributors still have concerns over the validity of the some of the assumptions contained in the current version of the ODV Handbook, and wish these to be addressed.

28. Transpower however have indicated their preference for the IHC approach over ODV, for new assets. As there is a lesser requirement for Transpower's regulatory performance to be directly compared with the distributors, Transpower's specific requirements should be considered. However, the point

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raised by the Electricity Networks Association<sup>13</sup>, that the boundaries between transmission and distribution are arbitrary, subject to competition and may change, is relevant. Should the basis of valuation of assets be different at the boundary, then investment decisions may be distorted by the different valuation approaches.

29. We believe that it should be possible to resolve this issue by either:

- requiring Transpower to value its system fixed assets at ODV for regulatory purposes going forward, and ensuring that the ODV methodology, Handbook and process for updating the Handbook addresses Transpower's concerns with the ODV method and approach; or
- allowing Transpower to value its ongoing system fixed assets for regulatory purposes using the IHC method, but ensuring that there are sufficient checks in the methodology and its application that ensure a valuation is achieved which reflects the same principles underpinning ODV, such as efficient investment.

Either approach should be open to input from the distributors, as well as Transpower and the Electricity Commission, as it is developed.

### **Indexing of Valuations**

30. If the Commission were to ordain a single valuation methodology for lines businesses, and if that methodology were ODV, then the accuracy of the index

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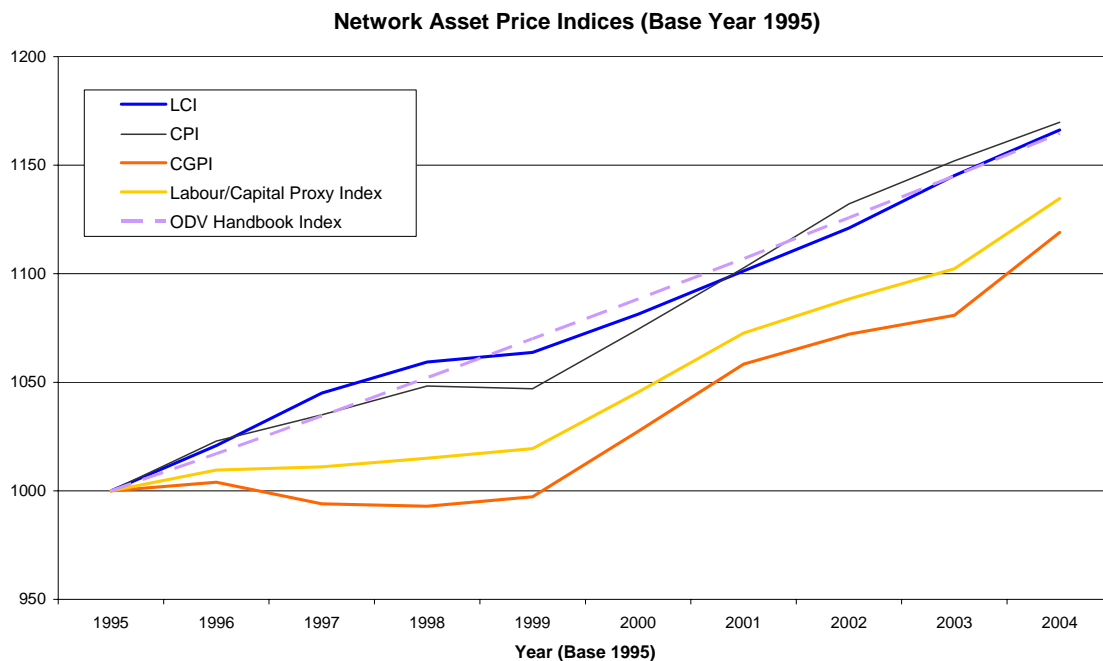
<sup>13</sup> Conference Transcript, Day One, Page 164

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used to roll forward index the valuation in the interim years between revaluations is less important than under the IHC approach, where there would be no revaluation. Any anomalies between the movement in asset cost and the Consumer Price Index (“CPI”) would be removed at the time of the revaluation, although they would exist in the interim years. These anomalies however are unlikely to materially impact on the relative performance of distributors over this period.

31. As requested we have examined further the price indices which could possibly be used in the periods between full ODV revaluations. We have looked at the last nine years of data for the Capital Goods Price Index (“CGPI”), the Labour Cost Index (“LCI - all costs, all industries”), and the CPI. In addition, we have constructed a proxy index comprised from the CGPI and the LCI, based on weights for capital and labour employed in a typical network project of two thirds and one third respectively. As a check we have also considered the increase in the ODV standard replacement costs between the 2000 ODV Handbook, which used 1994 asset prices, and the 2004 ODV Handbook which used 2004 asset prices. For the purposes of our analysis the standard replacement costs were weighted using a typical breakdown of standard asset categories derived from a sample of urban and rural networks. Actual price increases as represented by movements in ODV standard replacement costs show an average growth rate of 1.7 per cent between 1994 and 2004.
32. The graph below shows these price indices for the last nine years.

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33. In the above graph, it can be seen that over the 1995-2004 period, capital price movements were considerably more erratic than the CPI. Labour on the other hand closely mimics CPI growth. The combination of the capital and labour prices in the Labour/Capital proxy index smoothes out to some extent the more erratic capital movements, while still accounting for the lower average price growth in capital.

34. As an interesting coincidence, the ODV Handbook Index closely aligns with both the CPI and LCI average growth rates, although this is only a point to point index, as we have no record of the price movements in the interim years. This index however excludes the impact of increased replacement cost multipliers and traffic management costs in 2004 and therefore it will be understated at this point. Overall, the ODV Handbook Price Index casts doubt on the validity of the proxy measure derived from the CGPI and the LCI and

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based on the data available to us we cannot be certain that input prices for the electricity industry are materially different to the CPI.

35. As we have stated previously, the CPI is not a theoretically robust indexing tool to use for the revaluation of network assets. However, given the inconsistencies in other input price data, we believe that it may be pragmatic to recommend that the CPI be used for in the interim periods between full revaluations as it is the simplest index to implement. Going forward, however, we continue to support further investigation into the development of a more robust asset price index specific to the electricity industry.

#### **Certifications by Directors**

36. On reflection, we support the Commission's proposals for disclosed information to be certified by Directors, rather than managers as this is consistent with good corporate governance protocols.

#### **Information Requirements of Retailers**

37. We observed with interest the conference presentation by representatives of Genesis Energy and in particular their requirements and suggestions for information disclosures. In response to this presentation we note the following:

- Retailers have a unique opportunity to negotiate individual Use of System Agreements ("UOSA") with every network they use for distribution services which may (and to the best of our knowledge already do) include the specification of information to be provided to the retailer, and service level obligations. This is an efficient mechanism for addressing any issues

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retailers may have with the performance of and/or understanding of the performance of a lines business. It is the experience of the lines business which support this submission, that in practice retailers rarely use the mechanisms available to them through UOSA to seek out explanatory information about lines business performance.

- We also note with interest Genesis Energy's concern over common line charges for consumers who receive differing quality of supply. In response we note that many factors contribute to how prices are set for line services including both quality and costs to supply. In some instances consumers who receive lower standards of service, also incur higher costs of supply due to location, or terrain for example. As a capital intensive industry cost of supply closely follows density measures. Rural customers (low density) have the highest asset values per customer and also high operating costs per customer, for example vegetation management is most arduous in rural areas and the costs are getting worse. For reasons of physics and economics, rural customers are supplied on radial overhead networks so inevitably their reliability will be lower than on the urban, meshed, and more likely underground, networks which are also less capital intensive per customer. It is unrealistic to expect that rural customers can receive the same quality of supply as urban customers, at the same cost. The higher density of consumers in urban areas enables n-1 reliability, for example, to be achieved at significantly lower cost than in rural areas. It is therefore not possible to draw a direct correlation between price and quality of supply for all consumers
- We would support disclosures of line charges on bills by retailers. We note Genesis Energy expressed concerns about how much information is included in bills and how to accurately disclose line charge information, but

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we believe the customer invoices are the most direct means of showing a customer how much they incur by way of line charge, because they will reflect their own consumption patterns for the current period. It will also ensure that the benefits of the regulatory regime, where they result in reduced prices, will be transparently passed on to consumers by retailers.

- We do not support Genesis Energy's proposal to create a database for every ICP showing reliability data and explanations for outages. The costs of creating and maintaining this would be prohibitive. As Genesis Energy explained, when necessary they are able to approach a lines business to seek explanations about specific outages, and that in their experience this information was always forthcoming<sup>14</sup>. This practice should continue. Our suggestions for improved reliability reporting have already been addressed above.
- Customer complaint information should be analysed and distributed by the retailers who manage the call centres. This would be a far more efficient process than requiring disclosure by lines companies who (with some exceptions) do not have access to the majority of the customer inquiry data. There may also be value in seeking information from the Electricity Complaints Commissioner about how many complaints are received about line companies, and for what reason.

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<sup>14</sup> Conference Transcript, Day One, Page 101

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We thank you for the opportunity to present this cross submission and we would be happy to discuss these points further if required.

Yours sincerely



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