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UNISON NETWORKS LIMITED

Submission

to the Commerce Commission

in respect of

Review of the Information Disclosure Regime

2 March 2005

1. Introduction

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

In general, the information disclosure regime was established as part of the light handed regulatory era where there was a presumption that if information was in the public domain then a wide range of interested parties could access and interpret the information. In reality, there are few groupings of the wider audience who are willing or capable of engaging with issues such as the complex trade-offs between price and quality, the optimality of network design and performance or the efficiency of asset construction, maintenance, operation and valuation.

The regulatory regime has evolved into a heavier handed model and the information disclosures are more appropriately perceived as regulatory accounts and performance measures. With this context in mind, Unison's high level views on information disclosures are:

- The need for the light-handed process of disclosure has been over taken by the heavy-handed price-path threshold regime, eliminating or at least reducing the need for disclosure.
- There should be recognition that the increasing prevalence of market-based processes for setting parameter values is consistent with the Commission's preference for market-based processes and should further reduce the need for disclosure.
- The current ex-ante "disclosure" of prices and service levels through such processes as AMP disclosure and customer consultation is preferable to ex-post disclosure which only allows corrective action to be taken rather than preventive action, and that the Commission should encourage ELB's in the direction of such ex-ante "disclosures".
- Some benefits of mergers and acquisitions must be available to line businesses to release efficiencies from consolidation. This means that consumers must either share in both merger gains and merger losses or neither.
- There seems to be little practical weighting given to the Commission's stated principle of minimising compliance costs.

2. The Commission's Questions

Question 1

Historical Context

The historical *raison d'être* for the Information Disclosure regime has been overtaken by both the price-path thresholds regime and the increasing prevalence of market processes within the industry.

Question 2

Statutory Framework

The view expressed in para 76 that, based on section 57T of the Commerce Act, the information disclosures should not be restricted to the narrow scope of “electricity distribution and transmission services” is disputed. Section 57T is clear that the purpose of subpart 3 is “*is to promote the efficient operation of markets directly related to electricity distribution and transmission services*”. Any “widening” of the scope of information disclosure requirements should only be for the purposes of reconciliation. Such reconciliation should be available to the Auditor of the disclosures and should not form part of the publicly available disclosures.

The point of the regulatory regime is control monopoly behaviour in the long term interests of consumers. Accordingly, care must be taken not to bring in, and thereby disincentivise, legitimate non-monopoly initiatives.

Question 3

Electricity Commission

The requirements of the Electricity Commission on lines businesses is not sufficiently well defined at present to answer this question.

Question 4

Information needs

The informational value to lines businesses is low and is not especially enhanced by making the information publicly available. Compendium information that is published is of some interest but is not of high value.

Question 5

Objectives and Principles

The Commission’s implementation principles are also broadly correct but obviously at an implementation level there will be a tension between providing information that meets the four criteria of being transparent, relevant and understandable, consistent and accurate, and timely, and the single criteria of being cost effective. Obviously ELB’s have a keen interest in minimising costs but certainly in Unison’s case there is a lack of confidence that this criteria is given much weight.

Of the principles, consistency is a difficult one because the assumption that all ELB’s are broadly comparable is flawed. Unison strongly contends that because each ELB is generally only comparable to 1 or 2 others (and most ELB’s know which ones they are) that further levels of prescription based on the (flawed) premise of enhancing comparisons would be at odds with the Commission’s stated principle of minimising compliance costs.

On the issue of being understandable, it is hard to imagine who other than consultants, analysts and the Commission itself would be interested in reading disclosure statements.

Unison agrees with the principle of consistency and accuracy, but is concerned that at a practical day-to-day level the Commission seems guided more by the need to keep the numbers in order both between years and between ELB’s than in encouraging activities that will create value.

Question 6

Role of disclosure information

The regulatory regime has evolved into a heavier handed model and the information disclosures are more appropriately perceived as regulatory accounts and performance measures. Accordingly,

Question 7

Degree of prescription

There is no material need for greater prescription.

Question 8

Projections

The provision of prospective financial information is not supported. This would only seem appropriate in the context of a rate case discussion. As such, it seems to be leading to even greater intrusion into the business. If this is going to happen then it should be the result of an explicit change in the regulatory framework rather than by stealth.

The provision of forecast information would result in significantly more complex audit issues and, because of the potential for forecast variation the potential for liability on the business (eg prospectus type information).

Current prospective information included in the AMP is generally heavily caveated that its does not represent a commitment. The ability to provide such caveats in the context of financial forecasts would appear to be much less.

Question 9

Cost allocation

There is currently prescription of cost allocation. ACAM deals with costs between a monopoly service sitting along side contestable services.

The Commission's concern over the allocation of common costs between monopoly activities within the same business but in different industries (eg electricity and gas) seems to be at odds with its desire for (intra-industry) consistency/comparability and that consumers should not be affected by ownership, ie they should be indifferent between the utilities being owned by a single owner or by two separate owners. This suggests that the benefits of consolidation/horizontal integration should go to the business owner(s) rather than the consumers.

Question 10

Prescription of specific aspects

Unison's views on treating the following items are...

- Capital contributions – It would be preferable if it was recognised that a portion is capital contributions typically relates to investments required to strengthen the network at a later date, ie as the load builds up. This should be treated as a prepayment and brought to account over time, eg up to five years following livening of a sub-division development.
- Working capital – working capital, excluding cash and investments, should be identified for inclusion in operating capital.

- WUC and FDC – At a theoretical level, the appropriate options are:
 - Include WUC in the operating capital base if finance during construction costs are not charged, ie investors get their return through the annual revenue calculation while the assets are being built; or
 - Exclude WUC from the operating capital base if finance during construction is charged, ie investors get their return on the higher asset value over the life of the investment.

ODV should assume interest during construction in the standard replacement costs, which points to the latter treatment as being the preferred. However, if a firm adopts the IHC valuation approach and if capital expenditure is rolled in at cost and if the firm does not (for cost efficiency reasons) capitalise finance costs during construction then the firm should be able to include WUC in its operating capital base.

- Expenditure capitalisation - Disaggregating CapEx into categories such as replacement, extension or enhancement may have merit but it is unlikely to create the precise comparability that the Commission appears to be seeking. For instance an older network that is experiencing high growth could essentially replace worn out assets and classify the expenditure as enhancement rather than replacement.
- Customer rebates & discounts – Rebates, discounts and line charge holidays should be added back to revenue to provide a gross revenue number. Any tax saving the firm has derived from these items should be added back to the tax charge. This equates these options with the option of providing a dividend to the owners, which is the only option where the owner base and the customer base do not match.
- Treatment of tax – The disclosure of financial information ultimately results in an ROI number on a similar basis to the assessment framework the Commission has used in Airports and Gas and has outlined in the Assessment and Inquiry Guidelines for electricity businesses. These assessment framework purports to reflect an efficient entrant firm. However, reliance on cash tax captures a potentially wide range of company specific issues not relevant to the efficient entrant firm analysis. Accordingly, Unison strongly prefers that prima facie tax is used, as this more closely reflects the costs faced by an efficient entrant firm.

Under International Accounting Standards, all firms will have to account for tax on a consistent basis that will result in prima facie tax being reflected in the profit and loss statement and deferred tax recorded on the balance sheet.

This prima facie tax charge should be calculated based on the regulatory disclosure accounts. The tax charge should reflect tax depreciation based on the ODV. It is not appropriate or consistent for the tax benefit of costs to be taken into account in regulatory accounts or the assessment framework when the underlying costs are “disallowed”.

If prima facie tax is used then the deferred tax balance should be included in the operating capital base for calculating ROI.

- Adjustments following mergers or acquisitions – mergers and acquisitions have had an adverse impact on the disclosure data. However, Unison is opposed to any proposal that financial information is disclosed on a disaggregated basis for non-contiguous networks on an ongoing basis. This leads to a range of cost allocation issues that are unlikely to add to the value of that information.

It is acceptable that in the year of acquisition firms should be required to make special disclosures, preferably for the existing business as if it had not merged or acquired and for the acquired part for the period post acquisition.

The issue exists in respect of information pre acquisition for a business that ceases to exist as a result of the acquisition, as in the case of United Networks, or where the assets are acquired but not the company. The acquirer in those situations does not have information preceding the acquisition. Such situations should be the exception rather than the rule.

- Disclosure of related party transactions – no comment
- Treatment of transfer payments – Unison believes that the current disclosure regime is prescriptive enough to broadly prevent transfer payments being used to unreasonably allocate costs to a regulated business unit. As many of these costs will be market-based or have very strong proxies the need for inclusion in the disclosure becomes questionable.
- Treatment of insurance – insurance is a legitimate business expense for risk mitigation and transfer. However, where risks cannot be economically insured the risk is often carried by the business. This is not a systematic risk and as such is not compensated for in the WACC. Lines businesses are not (local or central) government guaranteed and often have limited access to additional capital (debt or equity). Owners should not be required to carry this risk without compensation. Businesses should be able to make an adjustment for uninsured risk where this is dealt with by setting aside specific funds or through a captive insurance company or similar arrangement. Where firms do not make an adjustment for uninsured risk the Commission should acknowledge that an event of loss is a pass through or mitigating factor in respect of a price threshold breach.
- Treatment of pass-through items – no comment
- Disclosure of investment in transmission bypass – Unison takes the view that transmission bypass is a market-based process, and should therefore be excluded from disclosure. It is acknowledged that bypasses may distort both the revenue and transmission cost components of the price-path threshold and would urge the Commission to ensure that whatever decision is reached in regard to disclosure that it does not discourage pursuit of such opportunities.
- Disclosure of investment in DG – Unison is delighted that the Commission recognises DG as a substitute for electricity line services, and would encourage the Commission to contextualize this as a competing good or service that should be exempt from regulation rather than being seen as complicating it.

From an ELB's perspective the generated energy is really a side issue. The real issue is the value of electricity line services derived from the DG, such as reducing transmission charges or avoiding network investment. Again, adopting a market-based mechanism for valuing DG suggests something along the lines of the avoided cost of network investment or capitalised avoided transmission costs (recognising that there will be a multitude of sub-issues involved).

Unison would agree that a common sense materiality limit is worthwhile given that DG currently has minimal penetration, and would further suggest as DG becomes more prevalent over time and electricity line services become increasingly contestable, the need for disclosure will decline.

- Disclosure of investment in load control – The Commission has presented two issues that require separate responses. In regard to the value of CapEx that can be deferred by judicious load control, the deciding factor needs to be firstly whether the ELB has retained control of the load control system following separation in the late 1990's and secondly whether opportunities to defer CapEx actually exist.

With regard to ELB's being paid for controlling load on behalf of other parties, Unison contends that a common sense materiality limit should prevail as to whether this needs to be included in the disclosure.

Question 11

Disclosure line items

No comment

Question 12

Disclosure further detail

Unison takes the view that because the disclosure regime is so highly prescriptive that any further information such as notes to the accounts should be minimal. There seems little point in the disclosure accounts replicating notes out of the annual accounts such as financial instruments. The translation from audited financial statements to regulatory/disclosure accounts is audited to confirm that the prescribed processes and rules have been applied. There seems little benefit in providing further working papers so other parties can repeat the exercise. This seems analogous to providing the bank reconciliation in the annual accounts because the bank balance is reported there.

Question 13

Reconciliation

As noted above, Unison takes the view that there is little if any need to reconcile regulatory accounts with financial accounts because they fulfil two totally different purposes. The prescription of preparation rules and the requirement to have the application of those rules audited should be sufficient for users to have confidence that the information is reliable and represents the lines business activities of the firm. The provision of information in respect of other, potentially contestable, to enable reconciliation is inappropriate in the context of those activities being contestable.

Question 14

Role of valuation

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

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

The conclusion to be drawn is that the disclosure of earnings performance, underpinned by a particular valuation methodology, will become a major plank in the Commission's delivery of outcomes that meet the purpose of subpart 1 of Part 4A of the Act.

Question 15

Valuation handbooks and guidelines

This is best dealt with in the context of decisions on valuation methodology. To a large extent it depends on the choice being offered between different valuation methods and the need to document procedures for IHC (for example) and to change procedures for ODV.

Question 16

Valuation reporting

No comment

Question 17

Measurement of returns

The only relevant return measure is the ROI as this is directly comparable to WACC. The computation should logically mirror that used in the assessment framework, subject to resolution of issues such as the treatment of tax.

Question 18

Measurement of productive, dynamic and technical efficiency

Allocative

As noted above, Unison believes that the ROI is the best measure of allocative efficiency.

The Commission has rightly observed that the existence of a "surplus" in any one year does not necessarily indicate that the business is exploiting its position. For example, this may result from fluctuations, such as climatic cycles that affect volumes in ways not anticipated when tariffs were set.

Productive

While it is good to seek simplicity, it is likely to lead to further criticism of the resulting measures unless a number of factors are reflected in the measure. This invariably means that it is not going to be simple. The origin of the different denominators is the recognition that because of density issues, ICPs did not necessarily drive direct costs. If a single, common denominator is being sought, Unison would prefer system length.

Dynamic

Measuring dynamic efficiency is a complex process. Process and ex-ante efficiency assessments through such means as AMP disclosure and customer consultation are probably the best means of ensuring an efficient allocation of assets over time.

Technical

This is not defined in the document but is assumed to mean energy efficiency measures.

Load Factor: this is considered irrelevant and not particularly useful. Distribution Businesses provide capacity and access. Issues of energy utilisation against that capacity is mostly beyond their control, except for limited load control.

Capacity Utilisation: This is a useful measure as long as it is defined clearly in terms of coincident peaks, extraordinary weather events and takes account of peak lopping using load control.

Loss Factor: This is of limited relevance. Distribution Businesses are incentivised to consider optimisation of losses in their network and equipment design for voltage compliance and to minimise maintenance costs. In addition, non-technical losses relate to theft, reconciliation and energy metering issues. These are mainly beyond the control of the Distribution Business.

Question 19

Disclosure of statistics

From Unison's perspective it would be preferable that one single disclosure be made to one government agency and that any additional requirements such as the MED's need to publish statistics be derived from such a single disclosure. Given that most of the disclosure, valuation and price control work is now performed by the Commission it would be preferable to make a single disclosure to the Commission under Part 4A.

Question 20

Measurement of quality

Ideally, reliability measures should be linked to service level requirements. This would mean more specific measures, ie defined and assessed based on customer groups, depending on customer type and location. The price-quality trade-off will be different between lines businesses and, within a line business, between customer groups. This means that the principle of consistency is less well supported but the important issue is that, within a lines business, the expectations of service are clear and the measure indicates how well those expectations are being met.

Measures such as Supply Frequency are not helpful, because it is beyond the control of the lines business. Similarly, power quality is not a practical measure.

Question 21

Terms and conditions, line charges and pricing methodologies

Unison believes that it is essential for all disclosures to occur within a single consolidated legal requirement overseen by a single government agency. While there are two jurisdictions, the Electricity Commission is charged with establishing standard contracts and pricing methodologies. While these are "models" there is a clear signal that adoption is not going to be "optional". It would be unfortunate if the Electricity Commission were to require further disclosures in this area in order to monitor the rate and extent of adoption of their "models".

Disclosure of mass market terms & conditions and line charges solely on each ELB's website is an acceptable disclosure burden. However disclosing terms & conditions and line charges for large commercial and industrial customers and pricing methodologies would reveal information that is sensitive to both the ELB and the customer.

In regard to the last sentence of Q21, Unison would respectfully request that instead of ensuring that the Commission's proposed objectives and principles are met, the bigger picture of how relevant those objectives and principles are in light of the increasing market-based disciplines that are being imposed on ELB's.

Question 22

Auditor's reports

The compliance audit approach is appropriate and the current scope of audit activities is appropriate. Unison does not support extending the scope of the audit role as this will only lead to additional cost, with little additional benefit.

Question 23

Auditor's independence

Independence is a fundamental part of the auditor role. This gives confidence to external parties particularly in terms of compliance focus of the audits undertaken.

Question 24

Certification and statutory declarations

The certification process is satisfactory. The requirement for statutory declarations is an unnecessary administrative burden which adds little to the value of the certification process. Responsible directors do not add their signature to information, especially for public disclosure or provision to a government body or regulator, lightly. The general practice of signing financial statements does not require a statutory declaration and it seems to be excessive in the case of information disclosures.

Question 25

Publication channels and mechanisms

Unison believes that the internet is the most suitable means for publishing any and all information that is required to be disclosed (but having regard to Unison's previous comments that commercially sensitive information should not be published at all) this should be in PDF format. Provision of information to the Commission, as required by the Commerce Act evidences compliance and timeliness. This should eliminate the need for hard-copy publication by such means as the Gazette. Having the information available in hard copy on request, within certain time frames and at a reasonable cost is also appropriate.

Question 26

Timing

Unison believes that the current times allowed for preparing and publishing disclosures are acceptable, and that the current regulatory balance date for ELB's be retained as 31 March.

Question 27

Publication of Commissions summary and analysis information

It is useful for the Commission to publish a summary of the information, however it is better for industry and analysts to undertake the analysis they consider appropriate for their varied needs.

Question 28

Retention of information

Unison believes that an appropriate policy guideline is that all data should be retained for the seven years that statutory data must be retained for, and that retaining such

information on an ELB's web server and backed-up to CD-ROM's or similar or retained in hard copy should suffice. These requirements should probably also include the requirement for such information to be preserved through merger processes.

Question 29

Implementation priorities and sequencing

It is impractical to seek to implement any of the possible changes emanating from the Commission's consultation process with effect from 31 March 2005. As was seen with the retrospective application of the revised valuation handbook, such an approach inevitably leads to delays in publication and undue pressure on firms that are operating with limited resources.

The issue on the critical path is the valuation method choice and the resolution of issues and concerns with respect to the Commission's approach to the ROI calculation and its earnings performance assessment framework (eg the treatment of tax). The Commission also needs to consider the incentives it is putting around mergers and acquisitions before cementing in valuation and disclosure rules that limit efficient business activity.

Question 30

Implementation process and timeline

The proposed timetable for the information disclosure is appropriate.

Question 31

Workshops

Unison believes that work shops would be useful for clarifying detail, and would be most interested in a work shop on Asset Valuation.