
Information Disclosure Regime and Valuation Choice for System Fixed Assets: Cross-submission

18 April 2005

Introduction

1. Powerco welcomes the opportunity to make this cross-submission to the Commission's Information Disclosure and Asset Valuation Choice Inquiry. The principal purpose of this submission is to address the specific questions raised by the Commissioners and its expert advisors during Powerco's presentation to the Commission's conference on 7 April 2005.
2. Powerco has also asked Jeff Balchin, Powerco's economic expert witness, to address the specific matters that were raised during his presentation to the Commission. Jeff Balchin's evidence is appended to this submission.
3. Each of the Commission's questions is addressed in turn. In addition, Powerco has also addressed the discussion on pages 353 to 360 of the transcript in relation to the level of disaggregation that consumers would find meaningful and the costs to Powerco of providing it. For convenience, we have provided this information in the format of an answer to an additional question, labelled Q4(b), to those questions set by the Commission.

Questions raised by the Commissioners and its expert advisors

Q1. Please provide the model showing the assumptions underlying the graph in the presentation slide headed "The Wall of Wire". (Day 3 Transcript, p 336).

4. The model and assumptions underpinning the "Wall of Wire" slide reflects Powerco's asset management data and was prepared by Margaret Beardow of Benchmark Economics. In response to the Commission's question, Powerco has asked Benchmark Economics to explain the assumptions underpinning the model. The paper from Benchmark Economics is provided at attachment 1 to this submission.
5. Whilst Benchmark Economics has received confidentiality assurances from the Commission in regard to supplying the model itself, it is felt more appropriate if Margaret Beardow were to present this to the Commission in person. This would enable her to explain first hand the workings of the model and its underlying assumptions. Powerco agrees with this proposal and will revert to the Commission with suggestion for how and when this can be achieved.

Q2. Please explain the relevance of the Australian electricity regulatory experience and evidence presented vis-à-vis the regulatory regime that has been put in place for lines businesses in New Zealand. (Day 3 Transcript, pp 347 and 350).

6. In answering this question, it is worth noting that regulators tend to gain comfort from reaching decisions on X factors that are not out-of-step with decisions reached in other jurisdictions, including overseas regimes. In fact, the Commission itself made references to X-factors in other jurisdictions to add weight to its view that price reductions are warranted in New Zealand. In this context, the recent regulatory decisions in Australia are relevant to New Zealand.
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7. Under the information disclosure regime (prior to the introduction of price thresholds) the New Zealand companies and their stakeholders had continual regard to the performance of lines businesses in other jurisdictions. If price control regulation forced lines businesses in Australia and the UK to work their assets harder, then by inference this also had some impact on Powerco's operations. Therefore, Powerco does not support the view implicit in the Commission's question that the regimes in Australia and New Zealand need to be directly comparable in order for the Australian regime to have some relevance to New Zealand.
8. More specifically, however, Powerco's submission is that the Australian regime has some direct relevance for New Zealand in terms of the regulatory errors that have apparently been made in Australia in recent times. Recent regulatory decisions in Australia are now approving quite significant price increases, whereas earlier decisions had required price reductions. In Powerco's submission, this evidence strongly implies that the initial price reductions were not appropriate, and this begs the question: "On what basis did the Australian regulators reach these earlier decisions?"
9. Powerco believes that regulators have mistaken lines businesses' one-off decisions to run down development capacity and to increase asset utilisation as genuine long-term efficiency improvements. By examining past data without looking directly at the inferences for future investment requirements, the regulators have wrongly concluded that past productivity gains can be repeated in future. Two or three regulatory cycles have proved these initial assumptions to be wrong, and now price increases are needed in order to support future investment. Powerco's submission is that these lessons are relevant to New Zealand, even though the regimes are in some respects markedly different from one another.
10. It is also worth noting that Powerco has previously provided detailed evidence to the Commission regarding the work of the Productivity Commission in Australia. The Productivity Commission has criticised regulators for taking too short-term a view on prices – favouring price reductions at the risk of long-term investment. Similarly, this experience has relevance to New Zealand, as it does to other regulatory regimes around the world.
11. Powerco's interpretation of the Commission's question is that the Commission is also interested in the specific investment patterns in Australia and New Zealand, and how they compare given the differences in the regulatory regimes. To assist in addressing this more detailed question, Powerco has asked PB Power to examine these issues in a separate paper. As you may know, PB Power has extensive experience in Australia working for both regulators and regulated companies. We expect PB Power to report back to us in the coming weeks and we will of course provide this paper to the Commission on completion.

Q3. Please provide in detail the information that Powerco considers should be required through broader information disclosure covering the cost drivers for lines businesses. (Day 3 Transcript, pp 350-351).

12. In Powerco's submission, the information presently being collected is not fit for purpose. In particular, the scope of information lacks the necessary
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breadth to enable stakeholders to understand the challenges facing the companies in the next few years.

13. Specifically, it is an inescapable fact that the age profile of Powerco's assets – driven by large investments in the 1970s - will necessitate a large programme of replacement capital expenditure as assets reach the end of their useful lives. The information disclosure regime does not assist stakeholders in understanding the business' future expenditure requirements, because the regime tends to focus narrowly on the profit and loss performance, and returns on assets achieved in the recent past.
14. In essence, the information disclosure regime focuses on lagging rather than leading indicators. This makes the regime relatively weak in terms of informing future revenue requirements. In particular, Steven Boulton presented a slide at the conference that explained that the information disclosure regime does not provide information in relation to:
 - Asset age
 - Asset condition
 - Asset utilisation
 - Growth in demand and consumption

As such, the information disclosure regime does not provide information on the future optimum level of asset utilisation to avoid over stressing network assets, or whether the company is earning sufficient revenue to fund development capital expenditure.

15. Having noted the deficiencies in the present information disclosure regime, Powerco is also conscious of the need to manage the costs of providing information. Powerco has not yet reached a definitive view on what information should be included or excluded from the information disclosure regime. However, a key objective of the regime should be to inform customers of the future challenges that now face all lines businesses in New Zealand.
16. Powerco in the time available has not been able to quantify the detailed information it believed should be required in information disclosure in order to broaden the base to deal with the cost drivers of the electricity asset business. The areas to be covered as suggested in Mr Boulton's presentation at the Conference are: asset age; asset condition; asset utilisation and capital spend. Powerco would be pleased to contribute to the development of more detailed proposals at the proposed workshop sessions.

Q4(a). Please supply a copy of costs/capex in relation to the South Australian example referred to. (Day 3 Transcript, p 355).

17. An Excel workbook *Aus-NZ Capex-Opex Ratios.xls* is attached from which the slides presented by Mr Boulton at the Conference were derived. The Australian data for these charts was sourced from a report prepared by PB Associates for the South Australian Electricity Distribution Price Review 2004. The equivalent New Zealand data is from the
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PriceWaterhouseCoopers *Electricity Line and Gas Pipeline Business 2004 Information Disclosure Compendium.*

Q4(b). What level of disaggregation consumers would find meaningful and what would be the costs to Powerco of providing it?

18. Powerco was asked to comment on the degree to which data disaggregation was either desirable or possible with present information systems.
19. To answer these questions we have considered the information disclosure factors specified in Subpart 3 57T(1) and offer some comments on the issues involved in specifying and collecting the appropriate data components. The table at the end summarises the ease or difficulty in disaggregating these data elements down to network, grid exit point or feeder level.
20. In addressing these issues, the differences between the major portions of Powerco's electricity networks must be acknowledged as they largely influence the extent to which Powerco is able to provide more disaggregated information without significant additional cost.
21. A further factor for consideration is the degree to which data, in particular costs is either firmly identified (attributed data) or assigned based on some rule or methodology (allocated data). The accuracy or appropriateness of the method will inevitably determine whether or not the information produced is meaningful or otherwise.
22. A major difference effecting the disaggregation of revenues is the fact that post the UNL merger Powerco presently has two different pricing methodologies. That is one based on quantities metered at the consumers premises (ICP pricing) in the eastern region and one based on grid exit point quantities (GXP pricing) in the western region.

Profits

23. Profits are revenues less costs and as such disaggregation is dependant on the degree to which these factors can be split.
 24. Revenues are the product of price and quantity, the latter of which breaks down into numbers of connections (ICP's), energy volumes (kWh), installed capacity (kVA) and electrical demands (kW/kVA).
 25. There are two basic approaches to the derivation of disaggregated revenue information. One is to disaggregate the total revenues from the financial accounts and the other is to re-aggregate the prices and quantities up to the network or consumer group level required. Because of the diversity of price and quantity between consumers and the distribution of various consumer types between feeders and grid exit points the only accurate method is the bottom up approach.
 26. Some of this information is used for the process of price derivation and could be extracted from models used for this but in some cases further information would need to be sourced either from within Powerco's management and billing systems or from third parties such as retailers. This process in the past has proved to be fraught with difficulties, for
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example obtaining sufficient information on ICP data in order to calculate losses.

Costs

27. The present Information Disclosure Regulations require costs to be reported on a direct and indirect basis. Whilst the attribution of costs on this basis is open to some interpretation, the direct costs are primarily those direct associated with the operation and maintenance of the electrical network and indirect costs are corporate costs and overheads common to all networks and other parts of the companies business.
28. Indirect costs therefore require some form of allocation process, which generally means that as the disaggregation goes to lower levels the rules for allocation need to be more tightly defined if the end result is to be meaningful. It is unlikely that disaggregation below discreet network level would be worthwhile.
29. The identification of direct costs below the total network level depends upon the sophistication of the job costing system or other systems used to attribute costs. In Powerco's case significant changes would be required to fully identify these costs at the GXP level. As with indirect costs it is unlikely that attributing costs at a feeder level would be viable unless some simple allocation system was used in which case the accuracy would be in doubt.

Asset values

30. Powerco's investment in asset management systems means the extraction of asset values by asset type and network location is not a difficult or costly exercise. Information is already available at the GXP level and database queries could be written to break this down to feeder level at a reasonable cost. The provision of asset valuation information to this level in isolation however may not in general provide useful information to consumers and other interested parties. It should be noted that this type of information has in the past been provided on an ad hoc basis to large consumers or their advisors in discussions over pricing.

Quality/Security/Reliability

31. Powerco already segregates the industry standard measures of reliability down to feeder level for asset management purposes (refer Powerco's disclosure of its asset Management Plan). Some additional costs may be incurred in providing this information in a format that may be required for further public disclosure.
 32. Powerco's asset Management Plan also includes security of supply information by feeder type and asset utilisation information down to primary substation level.
 33. While it is not possible to quantify the level of expenditure required to supply more disaggregated data the following table attempts to indicate the relative level of resource required to meet the three levels beyond the present information base.
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Indicative assessment of providing disaggregated information in relation to Powerco's electricity networks

Factors	Level of disaggregation					
	Discrete network		GXP		Feeder	
	W	E	W	E	W	E
Prices	✓	✓	✓	×	×	×
Quantities	✓	✓	✓	×	×	×
Direct costs	✓	✓	⊖	⊖	×	×
Indirect costs	⊖	⊖	×	×	×	×
Asset values	✓	✓	✓	✓	⊖	⊖
Quality/security/reliability	✓	✓	✓	✓	⊖	⊖
Overall assessment	✓	✓	✓	⊖	×	×

Key:

W = Powerco western network region

E = Powerco eastern network region

✓ = Already disclosed or could be disaggregated at reasonable cost by amending existing information systems

× = Substantial additional cost to provide more accurate attribution or allocation. New information systems software development and/or hardware required.

⊖ = Some additional cost to provide more accurate attribution or more appropriate allocation. Substantial addition or amendment of existing information systems required.

Q5. With respect to the quote in Powerco's written submission taken from the advice in relation to cost allocation provided by NERA to the UK Rail Regulator: (a) what did the Regulator do, and (b) did the Regulator accept NERA's advice? (Day 3 Transcript, p 377).

34. The reference in Powerco's submission to NERA's study was to illustrate the widely accepted view that there is no single correct approach for allocating joint costs. NERA was commissioned by the Office of the Rail Regulator to provide independent advice on pricing issues that was intended to inform the regulator's approach to freight access charges. The Rail Regulator subsequently established a policy for freight access charges that allowed charges to be negotiated between an avoidable cost floor and a standalone cost ceiling.
35. The Rail Regulator's approach to freight access charges was consistent with NERA's advice that there is no single correct pricing method for shared costs (in this case network costs were shared between passenger and freight services). It should be noted, however, that Powerco is not aware of any specific statement from the Rail Regulator to the effect that it accepted NERA's analysis of the economic literature. Nevertheless, it is fair to assume that as an internationally respected economic consulting firm, acting in this case for the Rail Regulator, that NERA's review of the economic literature was accepted as accurate.
36. The relevance of NERA's advice (and the Rail Regulator's approach to freight access charges) is two fold. Firstly, it demonstrates that there is no single correct approach for setting charges or allocating costs. Secondly, the concepts of standalone and incremental costs are closely related to ACAM. The Rail Regulator's use of these concepts therefore further illustrates that ACAM is not 'wrong' from an economic perspective.

Q6. Powerco states in its written submission that the Return on Investment calculation should exclude the effect of revaluation gains. Please provide an economic elaboration of that view. (Day 3 Transcript, p 389).

37. Powerco has previously provided advice to the Commission on this issue in its submission dated 23 February 2005 on information disclosure. In this submission, Powerco stated:

"Powerco agrees that a single measure of returns would be simpler and less confusing to interested parties. Powerco agrees in principle with the economic theory that the inclusion of revaluation gains is appropriate as a measure of allocative efficiency. Increases in asset valuation provide an indication of increased profitability only when they are realised by either selling the asset at a profit or increasing prices to make additional returns on the increase in value. Powerco therefore does not agree that the inclusion of revaluation gains as income in the calculation of a rate of return measure is an indication of excess returns. In addition, the inclusion of revaluation gains makes the measure extremely volatile from year to year, and meaningful analysis and interpretation of time series information is therefore very difficult. Powerco's view is that the measure should be the existing ROI calculation but the effect of revaluation gains removed.

38. Powerco believes that this previous submission addresses the Commission's question. For completeness, however, we have asked Jeff
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Balchin to comment further on the answer he gave to the Commission at the conference.

Q7. Please provide views on the cost and benefits of the optimisation process under the ODV methodology versus some sort of prudence or efficiency process (whether ex ante or ex post, or both) under the indexed historic cost approach, including with reference to the economics advice previously supplied to the ACCC. (Day 3 Transcript, pp 397-398).

39. For a discussion of optimisation issues see Jeff Balchin's further submission attached.

Q8. Please provide a view on whether or not section 57U(1)(b) of the Commerce Act gives the Commission the ability to obtain a wide range of further information for the purpose of monitoring compliance with the information disclosure requirements, including further information that is related to businesses other than the regulated business. If Powerco's conclusion is that section 57U(1)(b) does not give the Commission the power to obtain information beyond the regulated business, then how might the Commission carry out its monitoring role? (Day 3 Transcript, pp 419-420).

40. The purpose of subpart 3 can be discerned from sections 57T(1) and 57V, in particular. It is about disclosing information and then comparing it. There are assumed regulatory consequences that flow from such a process. These have already been covered in submissions and are acknowledged here simply to contrast with the separate monitoring function signalled by section 57U(1)(b).

41. The reference to monitoring, in subpart 3, is less than satisfactory. There is no specific duty specified. There is no threshold stipulated for. Indeed, the reference to monitoring comes only in the context of specifying additional powers on the part of the Commission to obtain information. That is, the reference to monitoring appears by a side-wind. It is then a matter of statutory interpretation to give content and scope to what appears to be a statutory purpose that the Commission should monitor compliance with the section 57T requirements.

42. For the reasons that follow, Powerco submits that although the Commission does thereby have a power to monitor, and thus to obtain further information for that purpose, the exercise of that power should not be automatic or undertaken without careful assessment. Powerco points to the following:

- a) The statute does not clearly specify a duty on the part of the Commission to monitor other than incidentally as part of a power to obtain further information.
 - b) Subpart 3 contains a division of duties. The Commission is to specify its requirements. The lines business is to comply with those requirements, have them certified and audited, and then disclose them. While the purpose statement speaks of ensuring reliable information that is already addressed in the certification/auditing processes.
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- c) Any statutory power to obtain information compulsorily must be exercised carefully, in accordance with the purposes of the Act, and reasonably. It would not be reasonable, for example, for the Commission automatically to audit the auditors.
 - d) It follows from the above that the Commission must have good reason to doubt the reliability of the information provided before it exercises its powers to seek further information in terms of section 57U.
43. In the present case, these considerations are augmented by further considerations because the Commission seeks additional information. That is, the Commission proposes to seek information other than in relation to the regulated business or businesses of the relevant entities. Consequently, the following further considerations arise:
- a) Prima facie, the Commission does not have a right to obtain information other than in relation to the exercise of its regulatory functions. Powerco accepts, at a general level, that where common costs are allocated across a number of businesses, there may be circumstances where additional information can lawfully be obtained. Nevertheless, that concession is subject to the important qualification that such information must be directly relevant to the inquiry and reasonably sought.
 - b) No judgement can be formed, at this stage, as to whether there will be a narrow or wide range of additional information available in this way, or, indeed, any information at all.
 - c) The additional information obtained in this way cannot be used for any other purposes. In particular, it cannot be published as part of information disclosure. The further information supplied will almost inevitably be confidential and should be treated as such.

Q9. Please state the current position on the natural justice implications of the Commission publishing a summary and analysis of disclosed information where there is the possibility of adverse inferences. (Day 3 Transcript, pp 423- 424).

44. We presume that this question arises out of paragraph 25 of Powerco's written submissions dated 21 February 2005.
45. What the principles of natural justice require of the Commission vary in a given case depending on the facts and the particular circumstances, the nature of the power being exercised, and the statutory or other context under which the Commission is operating.
46. Depending on those circumstances, the observance of the principles of natural justice may require a right to adequate notice; disclosure of relevant information; "meaningful" consultation; and/or an opportunity to be heard and to have a fair hearing which can include the opportunity to respond to allegations of an adverse nature.
47. For example, in *University of Auckland v Tertiary Education Commission* [2004] 2 NZLR 668 at para 79 (HC) Williams J concluded, that where there had been widespread consultation (in that case it was in relation to
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developing “performance-based research funding”) interested parties were entitled to expect similar consultation and the opportunity for further input concerning any change of direction in relation to the issue originally consulted on. Moreover, if data had been supplied to the body for one purpose, but the body intended to use it for another, it was incumbent upon it to give the supplier of the information warning of that change of approach. Full opportunity must also be given to either limit the use to which the data could be put, or to dissuade the body from using the data in that way - in particular, from publishing the material.

48. Consistent with these principles, France J in *Electra Ltd & Ors v Commerce Commission* (23 March 2005, High Court, Wellington CIV-2004-485-389) accepted that where there is a statutory requirement to consult, then what is required in terms of consultation will depend on the circumstances but that there must be a reasonable opportunity for an exchange of views. A key fact was that the matter to which consultation related was not a “new rule” as had been discussed in *McInnes v Minister of Transport* [2001] 3 NZLR 11 i.e. if the effect of changes made to a draft rule is that it is so transformed that the decision maker is in truth really considering a completely new rule, then the consultation process must start again. France J concluded that on the particular circumstances of the case before her, and consistent with the principles just referred to, consultation had been adequate (paras 99 to 103).
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