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Paula Rebstock
Chair
Commerce Commission
PO Box 2351
Wellington

cc: Paolo Ryan
Manager Network Performance

30 April 2004

Dear Paula

CROSS SUBMISSION ON ODV HANDBOOK REVIEW

1. Vector appreciated the recent opportunity to present its views to the Commerce Commission as part of its review of the ODV Handbook. In Vector's view, the conference was an important opportunity for interested parties to discuss with the Commission a range of important issues. The purpose of this letter (being Vector's cross submission) is to:

- having reviewed the conference proceedings, summarise our views and recommendations to the Commission; and
- provide further information requested by the Commission during our presentation (attached as Annex A).

2. Notwithstanding the usefulness of the Commission deciding to convene the recent conference, Vector remains of the view, as noted at the conference, that further consultation is required (discussed below).

Summary of Vector's view

3. The key points that Vector would like to reinforce in this cross submission are (all of which have been canvassed in Vector's main submission and/or conference presentation):

- (a) whereas accurate valuations were not critical (given a focus on comparability) prior to the Commission's regulatory regime for electricity lines businesses, accuracy is now critical given the potential use of asset valuations for price/revenue setting;
- (b) when referring to 'accurate valuations', Vector means:
 - all assets required to provide the distribution service should be included (i.e. valuations should be comprehensive in nature);
 - valuations should be reflective of actual costs incurred, where these are demonstrated to be the efficient level of costs (subject to a test (discussed below) to ensure this is the case);
- (c) ODV valuations are only one component of the total valuation picture; the Commission should develop, consult on and publish an overarching valuation handbook that encompasses:
 - the purpose of valuation (noting that, in part due to a range of different Commission documents covering asset valuation, interested parties are not clear at this time as to what the Commission sees as the specific purpose of valuation);
 - disclosure requirements for valuations, including rationalisation of why they are required;
 - description of all permissible valuation methods, including the historic cost method (if adopted as an option in the Commission's final decisions) and how intangible assets are to be valued;
 - a process for updating valuation requirements over time, including the ODV Handbook (noting that the review of the Handbook has so far left this issue unaddressed; the Handbook update is only a milestone in an ongoing process over time);

- (d) further consultation is required given procedural shortcomings to date (outlined in Vector's main submission) , particularly given the work/analysis of the Commission's consultant, Parsons Brinckerhoff Associates, related to updating the Handbook costs and multipliers has not been transparent and tested by way of consultation (recommended procedural steps from this point forward are discussed below).

4. In our main submission and at the conference, Vector also canvassed a range of specific, detail issues related to the Handbook update, including insufficient asset costs (e.g. insufficient reinstatement and traffic management costs) and excluded assets. Vector has not repeated its views on these detailed matters here, but reinforces the importance of these matters being further considered by the Commission.

Test for use of actual costs

Actual costs only used where efficient

5. It has always been Vector's intent that actual costs could only be used where these are demonstrated to be efficient. There was considerable discussion on this point at the conference. We trust we sufficiently clarified for the Commission at the conference that 'efficient' costs is the goal (and the appropriate standard for regulatory purposes); but reinforce the point here given its importance.

6. With this submission, Vector has provided the Commission, on a confidential basis, with a typical invitation for tender document for large capital works (Annex B). The document shows the rigor associated with the competitive processes that Vector runs for such work, which, given their large scale, competitive nature and detailed project monitoring, result in actual costs that are efficient. Such a tender document, along with all subsequent documentation related to the project, is an example of what an auditor may expect Vector to provide for the acceptance of actual costs, where they diverge from the costs set out in the Handbook.

'Efficient' costs must be achievable in practice

7. While 'efficient' costs are not disputed, this does raise a secondary issue of what does 'efficient costs' mean? Is it some theoretical ideal, or something that is achievable in practice, akin to the concept of 'workably competitive' markets that the Commission has referenced in some of its other work? This issue was canvassed in some detail at the conference by Greg Houston of NERA (on behalf of Orion). Vector agrees with the view articulated by Mr Houston (Day 3 transcript, p372):

“There is no quibble that ODV refers to the concept of an efficient new entrant and to the efficient replication of the network under the deprivation scenario. We need to be clear that there’s no debate about that.

But the concept of efficiency must also be something that’s achievable because the concept involves hypothesising in your mind that if you were deprived of this network, what would it cost optimally to put it back. So, it must be something that can be done. It must be achievable. It must be feasible.

The proposed definition appears to go beyond any plausible concept of efficiency. It seems to represent what could be characterised as absolute perfection in every aspect of business’ performance. That absolute perfection is just not consistent with the real world experience.”

8. Immediately following that intervention, the Chair made clear that she found terminology like ‘perfection’ unhelpful as it did not readily equate to the appropriate benchmark of “what would happen in a competitive market” (p373). The resultant discussion between Mr Houston and the Chair then seemed to gravitate toward agreement that perfection should be *aimed for* (as required to survive in competitive markets) but not necessarily achieved in practice, due to the complex and dynamic environment in which businesses operate and the range of processes and decision-making considerations that are relevant.

9. Vector, therefore, supports a concept of ‘efficient’ costs that is based on a benchmark that is achievable in practice. Vector has submitted that qualifying contestable/competitive processes are the best way to determine ‘efficient’ costs, which, given such processes occur in practice, is consistent with the benchmark articulated here.

Options outlined by Vector for use of actual costs

10. In its presentation to the Commission, Vector set out two options for operationalising an actual costs principle in the Handbook, viz:

- Option 1 – a general, principle-based approach comprising:
 - a general specification of the actual costs principle;
 - approval of use of the principle by independent auditors;
 - (optional: independent audit by the Commission);
- Option 2 – a prescription of what the principle should mean in practice:
 - as for Option 1 (i.e. the three points above); and

- additional prescription of when, and in what circumstances, the actual cost principle could be used, for example, through specification of what constitutes a 'competitive process' (given such processes lead to efficient outcomes).

11. At the conference, Vector supported Option 1 on the following basis:

- it was simply a symmetrical application of a principle already encapsulated in the draft Handbook, i.e. the principle that actual costs be used where these are *less than* the prescribed maxima (under Option 1, that principle would be fairly and logically applied both ways);
- the draft Handbook already required lines businesses to demonstrate to their auditor what cost was appropriate to use for valuation purposes (i.e. not just adopt the maxima but prove what value between zero and the maxima was most appropriate) – that being the case, no *additional* work would be required to use actual costs above the stated maxima (where proven efficient);
- a general principle provided (appropriately) for flexibility as to when actual costs were appropriately used (noting any prescription would only constrain this and, therefore, unfairly rule out instances where they should be used);
- the Commission allowed auditors to sign off on similar processes in the context of the thresholds, i.e. with respect to 'beyond reasonable doubt' that services excluded from the thresholds are subject to 'effective competition' (in essence, the same test required to demonstrate actual costs are efficient, as revealed by 'effective competition' in their construction; and
- the Commission itself could re-audit ODV valuations, as it did in 2002 for its asset recalibration audit required by Part 4A of the Commerce Act.

Vector's view now closer to Option 2

12. With the benefit of further time, as well as discussion with the Commission at the conference and consideration of the conference transcripts, Vector now considers that something closer to Option 2 is preferable. While imposing some costs (specifically, prescription inherently reduces flexibility), Vector considers the benefits of a prescribed approach outweigh its downsides for the following reasons:

- the Commission has signalled it is concerned that Option 1 could be abused, such that actual costs that are not efficient enter the valuation of some lines businesses (Vector has been clear that prescription of the principle is far preferable to its outright abandonment, given concerns about the integrity of a general specification);

- prescription of the principle would provide guidance to lines businesses and auditors about when and in what circumstances the principle could be applied (discussed further below); and
- because prescription would discipline the use of the principle, the need for an additional audit by the Commission, even if only on a random basis, would be reduced (if not avoided altogether).

13. That said, the trick is to find the right balance between enough prescription on one the hand to give the Commission comfort that (where used) actual costs are efficient, and not over-engineering the prescription on the other hand such that it is unworkable in practice, overly costly or too inflexible.

14. Importantly, Vector considers this fine balance can be struck, as achieved by the test being put forward by Powerco, Unison and ourselves, based on audit input from PwC. This test is set out further below.

Further articulation of benchmark Handbook costs also required

15. As noted above, prescription of the actual costs principle would usefully provide guidance to lines businesses and auditors about when and in what circumstances the principle could be applied. An important complement to this prescription is articulating in the Handbook (or referencing an accompanying document) what the Handbook replacement costs and multipliers are based on themselves. If that is clear (and presently it is not), it will also assist lines businesses to prove to auditors departures from the standard Handbook costs (and base those departures on specific explanations referenced to the benchmark circumstances). This matter was discussed with the Commission at the conference by a number of parties, including Orion and the ENA; as just discussed, Vector supports their comments in this area.

16. In Vector's view, this transparency would be achieved by the analysis of Parsons Brinckerhoff being released for comment, then finalised and published. Once completed, it could be summarised in the Handbook in an appropriate form (e.g. a bullet point list of the considerations that underpinned a decision), or the Commission/PB report referenced given its contextual relevance.

Recommended test for use of actual costs

17. Vector, Powerco and Unison requested PwC to develop a test that can give the Commission comfort that actual costs are efficient (when the test is employed) and

workable in practice, both from the perspective of lines businesses, valuers, engineers and auditors. A letter from PwC is annexed to this submission (Annex C).

18. PwC have suggested (supported by Vector) that the following text be added to the ODV Handbook after Clause 2.11:

There may be instances where the adoption of the maximum replacement values included in Table A.1 are not appropriate due to specific circumstances associated with selected assets. Special circumstances will arise where the nature of the asset differs from those included in Table A.1 due to factors external to the lines business such as the environment in which the asset is located. In order to justify departure from the maximum values included in Table A.1, the lines business must document and provide the following evidence to support the adoption of alternative values:

- a) A description of and evidence to support the special circumstances pertaining to the relevant asset including the location of the asset or assets;
- b) The replacement cost for the relevant asset or assets, compiled in accordance with clause A.3; and
- c) Evidence to verify that the replacement cost for the relevant asset or assets reflects efficient costs, including evidence that the cost reflects competitive pricing and large scale construction and any other evidence required to reasonably determine that the costs reflect efficient costs.

19. As noted above, for actual costs to be accepted as efficient (where they diverge from the Handbook allowances), Vector would, for example, expect to provide an auditor with a tender document that demonstrated a competitive process, along with all subsequent documentation related to the project.

20. Vector notes that if the suggested test above does not meet with the Commission's approval for any reason, then Vector would be happy to work further with the Commission to develop something acceptable to it. PwC have also made this offer. As noted previously by Vector, while not required, further prescription of the test is preferable to its outright abandonment.

Procedural issues

21. In our main submission, Vector outlined a range of procedural issues related to the review of the Handbook. While the conference was a very useful addition to the Commission's process, it has not unfortunately mitigated many of the concerns that we have previously outlined.

22. Our primary concern is that the work and analysis undertaken to update the Handbook costs by the Commission's consultant, Parsons Brinckerhoff, has not been published for comment by interested parties. Ordinarily, and to its credit, the Commission goes to great lengths to subject its own (as well as others') information and analysis to public debate. Vector continues to be of the view that the Commission should do so in this instance.

23. As noted at the conference, Vector considers the following procedural steps should apply from this point forward (following cross-submissions and their publication by the Commission):

- Parsons Brinckerhoff meets with interested parties as required, including, for example, to elicit any further information on actual costs;
- a final draft of the Handbook is released for further submissions (with a short (say 3 week) turn around, including the work/analysis of Parsons Brinckerhoff so that there is transparency around the reasons for changes made;
- those submissions are published by the Commission with an invitation for cross submissions within, say, 10 working days; and
- the final version of the Handbook is published with an accompanying Commission Decision Paper and a final version of Parson's Brinkerhoff's report (as per Vector's suggestions above, the Handbook could also make reference to these other documents given their contextual relevance).

24. Valuations as at 31 March 2004 could then be prepared. Importantly, these additional process steps would not compromise the ability of lines businesses to prepare these valuations ex post.

25. Vector wishes to emphasise that, as the Commission knows, we do not ordinarily dwell on process or procedural issues; instead, we focus on working constructively and pragmatically with the Commission. However, in the case of the ODV review, Vector has held process concerns, and articulated these to the Commission in letters and submissions, since the review commenced. Unfortunately, many of these remain. We view the Handbook, and valuation generally, as a particularly important part of the Commission's regulatory regime and, therefore, it is critical that time is taken, including through additional process steps, to collectively ensure that we get things right.

Closing comment

26. In summary, Vector recommends the Commission allow actual costs to be used where these, based on a test, can be demonstrated to be efficient. Vector, working with Powerco and Unison, has suggested a test (recommended by PwC) that could be adopted in the Handbook.

27. Vector also suggests the Commission embark on further process steps to ensure that the new Handbook specification is optimal; the benefits of doing this far outweigh any costs, particularly given valuations as at 31 March 2004, which the Commission is wanting, can be prepared at any time ex post.

28. Thank you for considering this cross-submission. Vector appreciates the opportunity to make a further submission as part of the Commission's review of the ODV Handbook. We would be happy to clarify our views on any matter if useful.

Kind regards

A handwritten signature in black ink, appearing to read 'S. Mackenzie', written in a cursive style.

Simon Mackenzie
Group General Manager Networks

FURTHER INFORMATION REQUESTED BY THE COMMISSION

The Commission has requested that Vector provide information related to the following (copied from, and numbered as per, the Commission's request):

25. Please provide information on the cost of undertaking the economic valuation test. (Day 3 Transcript, pp 494-495);
26. Time permitting (and at Vector's discretion), please provide an estimate of the uplift in Vector's ODV valuation applying the draft ODV Handbook. (Day 3 Transcript, pp 497-298);
27. Please comment on the zone substation optimisation issue raised by Mr Gibbons. (Day 3 Transcript, pp 499-500);
28. Please contrast the FRS-3 and ODV valuation processes, particularly with respect to the issue of materiality. (Day 3 Transcript, p 509).

Vector's response to these information requests is set out below.

Qn 25: Cost of undertaking the economic valuation test

In 2001, when the 4th Edition of the ODV Handbook was applied for the first time, Vector (UNL) spent two person-months performing spur analysis for the ODV valuation.

While such a time consuming process was not required in 2003 due to a base level of work having been completed, it still took 2 person-weeks for the spur and ICP analysis to be performed at a cost of approximately \$4,000. The auditor's costs for the EV analysis came to approximately \$17,000.

The total cost of the EV analysis for 2003, therefore, came to approximately \$21,000. There was no EV write down for Vector's valuation.

Qn 26: Estimate of uplift in ODV from draft ODV Handbook

Due to other work pressures, Vector is not in a position to accurately quantify the effect of draft changes to the ODV Handbook on Vector's ODV valuation.

High-level preliminary estimates, however, show that there would still be a material shortfall in a valuation conducted using the Handbook (relative to the level Vector considers to be accurate), primarily due to the limitations of cable costs.

More generally, Vector does not consider estimates (or even detailed calculations) of the uplift from the draft ODV Handbook to be meaningful. The focus should be on ensuring an optimal specification so accurate valuations can result; not consideration of how much progress may have been made toward that.

Qn 27: Zone substation optimisation issue

Mr Gibbons' question (line 29 on page 499) was how Vector would treat a project that would subsequently be optimised out of the valuation as part of a series of zone substations being relocated to an "optimal" location and size. It is not completely clear from the transcript what Mr Gibbons meant in relation to a hypothetical optimisation of substations in relation to cost differences. If this response does not address the issue/concern, Vector would be pleased to discuss it further with Mr Gibbons or Commission staff.

Vector notes that lines businesses are not required to conduct a "green fields" optimisation for the purposes of ODV¹ by picking, in hindsight, perfect locations for network assets given current loadings. As such, zone substations and their associated assets would not be optimised out unless they were surplus to the load forecasts defined in the Handbook.

If a lines business invests in reinforcement of its network, and cannot include the entire cost of the reinforcement in its valuation (e.g. because the Handbook planning periods do not match optimal engineering planning periods) then the value excluded by the Handbook will be optimised out.

Optimisation of assets should not affect the inclusion of the project costs in the determination of efficient costs (if that project is of a qualifying nature).

¹ P28, Recalibration of Asset Values Of Large Electricity Line Owners – Closing Report, 1 August 2002, PB Associates

Qn 28: Contrast of the FRS-3 and ODV valuation processes with respect to materiality

The following table documents some of the process differences between FRS-3 and ODV valuations. We note that Vector uses the same materiality thresholds for both valuations. The table is not intended to be comprehensive in any way, but offers some observations within the time available that may be useful to the Commission. As a general comment, the vast majority of differences in ODV and FRS-3 valuations come from the ODV Handbook’s inadequate allowable costs - particularly with relation to escalations (via multipliers) to non-standard situations.

	ODV	FRS-3
Determination of Asset Values	<ul style="list-style-type: none"> • Handbook costs and lives are applied to standard Handbook assets. • Where the installation is non-standard (as defined by the Handbook), a multiplier is selected from within the permitted range and used to escalate the standard costs. The multipliers selected are determined using actual project cost data from significantly sized projects that have been put out to a competitive process. The Valuers verify that the multipliers used do not overstate the costs actually incurred. There is no leeway to increase the multipliers if the resulting Handbook cost is less than the efficient cost faced. • Non-standard assets (those not listed in the Handbook or which do not have a standard cost defined) are valued using actual project costs from significantly sized projects that have been put out to a competitive process. The Valuers verify these costs. 	<ul style="list-style-type: none"> • ODV Handbook costs and lives are used as the starting point for all assets. • The assets with a material impact on the valuation are selected for review. Actual project costs from significantly sized projects that have been put out to a competitive process are used to establish standard replacement costs. Assets with only a minor impact on the valuation are processed at the ODV replacement rates. Standard asset lives are reviewed where the Handbook is deficient. The latest information from manufacturers, industry surveys and our own experience with the assets is combined to determine an appropriate standard life. External, independent technical auditors test and verify the resulting life estimates. The Valuers audit the cost information and verify the resulting asset values.
Optimisation	<ul style="list-style-type: none"> • Handbook rules applied – based on load forecasts and utilisation levels 	<ul style="list-style-type: none"> • A “used and useful” test is applied
EV Testing	<ul style="list-style-type: none"> • EV testing performed 	<ul style="list-style-type: none"> • N/A

ANNEX B

VECTOR TENDER DOCUMENT

**(PROVIDED TO THE COMMISSION ON A
CONFIDENTIAL BASIS GIVEN THE CONTENTS
ARE COMMERCIALY SENSITIVE)**

ANNEX C

LETTER FROM PwC

(REFER SEPARATE .PDF DOCUMENT)