

Mark Franklin
Chief Executive Officer
Vector Limited
101 Carlton Gore Road
PO Box 99882
Newmarket
AUCKLAND

Steven Boulton
Chief Executive Officer
Powerco Limited
2nd Floor Council Building
84 Liardet Street
Private Bag 2061
NEW PLYMOUTH

Ken Sutherland
Chief Executive Officer
Unison Networks Limited
1101 Omahu Road
PO Box 555
HASTINGS

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Dear Sirs

ODV Handbook: Recommended Test for Use of Actual Costs in Qualifying Circumstances

Further to your submissions at the Commerce Commission's conference on the Optimised Deprival Value Handbook¹, we have considered the issue of departures from the table of standard replacement costs included in the draft Handbook.² In particular, we have considered under what circumstances it may be appropriate for departures from the table of standard values to be made. In addition, where departures may be appropriate, we have considered the principles that could usefully be included in the ODV Handbook to ensure any departures comply with the purpose for valuation and the principles of the deprival valuation methodology, including the Commerce Commission's objective of ensuring

¹ Commerce Commission ODV Handbook Conference, 14-16 April 2004

² Draft Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses, Commerce Commission, 23 December 2003, Table A.1, pages 26-30

PricewaterhouseCoopers
PricewaterhouseCoopers Tower
188 Quay Street
Level 22 Reception
Level 8 Mail Centre
Private Bag 92162
Auckland
New Zealand
Telephone +64 9 355 8000
Facsimile +64 9 355 8001
Direct Phone +64 9 355 8573
Direct Fax +64 9 355 8024

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valuations reflect efficient costs. In this respect, based on our own experience in valuing, reviewing and auditing ODV valuations, we have included in this letter suggested principles which lines businesses and auditors may use in such circumstances.

A table of standard values is a useful inclusion in the ODV Handbook. The replacement cost multipliers which accompany the standard values allow for location specific circumstances to be incorporated into valuations. These reflect common circumstances where the assumptions underlying the standard values require modification to reflect location influences such as soil type or transport costs. Assuming the values included in the Handbook reflect efficient prices these should not be exceeded, in the majority of circumstances.

It is not possible to consider every specific circumstance and the draft Handbook correctly incorporates allowances for those that are common to the industry. There will be selected assets however where additional external influences are experienced and where the standard values will not apply. In our view, rather than derive new replacement cost multipliers to be applied to standard costs, it is more appropriate to seek specific evidence pertaining to the cost of the asset or assets in question. We recognise that the table of standard costs is yet to be finalised and acknowledge that further work is required in this respect. In addition however, we believe the following principles should be included in the ODV Handbook.

Suggested Principles for Inclusion in the ODV Handbook

We suggest the following text be added to the ODV Handbook after Clause 2.11:

There may be instances where the adoption of the standard 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 standard values included in Table A.1, the lines business must document and provide the following evidence to support the adoption of alternative values:

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- 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.

Related Amendments Required to the Draft Handbook

In relation to the principles outlined above, it is our view that it is reasonable for the onus of proof for departures from the standard values to reside with the lines business undertaking the valuation. It is important to note however, that it will be difficult for lines businesses to provide compelling evidence unless the Handbook itself provides more information on the derivation of the standard values and replacement cost multipliers than that included in the draft Handbook. Put another way, 'the special circumstances' noted above will depend on what the benchmark circumstances are that the standard values in the Handbook relate to. It is also imperative that these values are regularly reviewed and updated. In this respect, we suggest that the draft Handbook requires amendment to include the following information for each category of asset included in Table A.1 and the associated replacement cost multipliers:

- the cost components and equipment included;
- the design and engineering standards adopted;
- any relevant location factors; and
- the date or period from which the standard values were derived.

In addition, clauses A.1 and A.2 in the draft Handbook must be amended to provide for the principles outlined above.

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We would be happy to provide further explanation to you or the Commerce Commission if required. If this test is not acceptable to the Commerce Commission, we would be happy to work further with the Commerce Commission in this respect. We do however consider that the proposed test meets the objectives of the valuation methodology; is workable in practice (from engineering, valuation and audit perspectives); has integrity (in terms of applying rigor to the process) and, importantly, will result in efficient costs entering valuations where the test is applied.

Yours sincerely



Lynne Taylor
Director
Corporate Finance



Craig Rice
Partner
Corporate Finance