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Graeme Wilson
Orion New Zealand Ltd
PO Box 13896
218 Manchester St
CHRISTCHURCH

Dear Graeme

Treatment of Easements in ODV Valuations

Further to your submission on the development of a handbook for Optimised Deprival Valuation of electricity lines businesses systems fixed assets, we have considered the issue of easements and, in particular:

- Whether easements are costs which would necessarily be part of the cost to a new entrant and, as such, whether they should be captured by ODV methodology;
- Whether they are tangible or intangible assets;
- Appropriate valuation methodology.

We set out our response as follows:

Background

Orion has a considerable investment in easements, which are typically in place to facilitate the following services:

- Underground cabling;
- Overhead lines
- Sub-stations (“green boxes” and some sub-station buildings);
- 66,000-volt transmission lines.

The easements typically result in perpetual tenure.

Most of the above services exist in urban environments with comparatively high underlying land values.

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We understand that many of the rights for the above services were created under the Electricity Power Boards Act 1925 (repealed in October 1994) and their continued existence is facilitated by existing use rights under the Energy Companies and Electricity Acts 1992; there are no formal easements in place. This type of easement is commonly referred to as a "notional" easement. The rights associated with notional easements are in some circumstances marginally less than those associated with formalised easements.

Since 1993, however, Orion has acquired many new easements on the basis of open market transactions where the "servient tenement" (the landowner) provides Orion ("dominant tenement") with an easement, but expects financial compensation to reflect the real or potential value loss to their land-holding and/or any disturbance or injurious affection.

Indeed, Orion now has a formal policy regarding easement procurement.

Typical Procurement Procedures

Orion's procurement procedures can be summarised in relation to three typical situations where the need for easements arise:

1. *Typical subdivision.* Consider, for example, a residential subdivision where the developer needs to reticulate power to the individual lots. The developer provides and installs the necessary cabling to each of the lots within the subdivision, and creates the easements to facilitate this installation. Once complete, Orion purchases ownership of the reticulation on the condition that the easements are transferred to Orion. While there has been no specific consideration by Orion to acquire the easements, the acquisition is effectively financed via a subsidised installation.
2. *Orion-initiated procurement.* Consider an example where Orion wish to install primary or network cabling or obtain a substation site in an area of land. Orion would enter into negotiation with the landowner and Orion's total cost of securing the easement would include a financial contribution (purchase price) for the landowner and the cost of all expenses associated with establishing the easement, such as survey and legal costs.
3. *Developer-initiated procurement.* Consider an example where a developer wishes to complete a small development, however, the existing electric reticulation has insufficient capacity. The developer would provide Orion with an easement, for no consideration, to establish a "green box" to facilitate the development. The

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developer would also pay for all costs associated with establishing the easement. In this instance, while sometimes Orion does make a small contribution to the creation of the easement, the cost to Orion of acquiring the easement is minimal.

Easements and the Hypothetical New Entrant

There are two reasons why easements should be captured within the overall ODV of a lines business:

- They would necessarily be part of the cost to a new entrant and should therefore be included as part of the cost base in the Targeted Control Regime;
- They are, in any case, tangible representing a subset of the property rights attached to land.

We set out our justification for these statements as follows:

The underlying concept of the Targeted Control Regime is that all costs that a hypothetical new entrant would incur should be captured. There is no doubt that an Electricity Lines Business (ELB) requires easements and that a hypothetical new entrant would necessarily incur costs acquiring them.

In some instances, it is acknowledged that the procurement of easements for an ELB could perhaps be negotiated more efficiently on the basis of a consolidated (not fragmented) negotiation. A hypothetical new entrant would, however, be faced with considerably more negotiation risk in relation to the easements that Orion had in place prior to 1993.

In terms of the Targeted Control Regime, it is appropriate to consider how the value of easements should be captured. ODV methodology seeks to value systems fixed, or tangible, assets. There has been some speculation as to whether easements are tangible or intangible.

We believe that easements are clearly tangible. Consider two hypothetical adjoining properties, Property A and Property B. They are identical in every way, except that Property B has an easement in relation to an underground cable that bisects the rear of the site. If these properties were put to the market for sale, Property B would sell for less than Property A. The value loss to Property B (effective reduction in that property's "bundle of rights") has effectively been transferred to the dominant tenement of the easement, the ELB. The easement has therefore had a tangible impact on the value of Property B and created a tangible asset in terms of the value associated with the dominant tenement.

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Referring to the three typical types of easements held by Orion and the procurement processes previously discussed, we believe that all of the easements that Orion holds have a tangible value. This is regardless of whether Orion incurred a procurement cost, and equally applies to the notional easements that were created pre-1993 and which do not have formal easement documentation in place. They are all costs that would necessarily be incurred by a hypothetical new entrant.

Valuation Issues

It is acknowledge that establishing an appropriate value for easements in the context of an ODV valuation is difficult.

The most common approach is to establish the value of an easement relative to an "easement to fee simple value ratio". For example, consider an easement area relating to an underground cable, with a freehold land value (reflecting 100% of the "bundle of rights") is \$100 per square metre. This value would be determined on a "before and after" or "with and without" approach. Then, if the market price for an underground cable easements is 50% of freehold value, the area of the easement would be valued at \$50 a square metre.

The servient tenement (landowner) may then also receive further financial contribution to offset:

- Possible injurious affection (such as the position of the cable impacting on subdivision potential of the land and or building development) and/or;
- Disturbance, to compensate for interruptions to the use of the land while the cables are being laid, maintained and upgraded.

In some cases, the resultant value of the easement may indeed be in excess of the freehold value. It is not untypical, however, for the acquisition cost of easements to be determined by simple, comparatively unsophisticated, negotiation.

Clearly, the valuation of an easement could vary significantly depending on particular circumstances. Consider, for example, an overhead powerline running through a barren, undeveloped rural area, as compared to the same powerline passing through a developed rural area with lifestyle block potential. Aside from the underlying land value issues (which would vary significantly), the impact of the powerlines on the adjoining land would also vary significantly.

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Ultimately, the cost to Orion of negotiating an easement with a landowner where the transaction occurs between Orion as a "willing buyer" and a "willing seller" in an arm's-length transaction wherein the parties had each acted knowledgeably, prudently and without compulsion, would be a fair representation of value as it would necessarily encapsulate the replacement cost of the easement to Orion. In circumstances where no consideration has (or is) paid for an easement, an *equivalent cost* should be estimated.

However, given the lack of consistent data in this regard and the issues associated with determining fair value, a more practical and pragmatic approach to valuation may be appropriate. Perhaps this could be addressed on the basis of an average cost of procurement per lineal or square metre, dependent on the type of easement required. However, such an approach would require further investigation. This investigation is not within the scope of this commentary.

Summary

We summarise our findings as follows:

- Easements would necessarily be part of the cost to a new entrant and should therefore be included as part of the cost base in the Targeted Control Regime;
- They are, in any case, tangible representing a subset of the property rights attached to land;
- Easements should therefore be part of ODV methodology of Systems Fixed Assets;
- All easements (whether formalised or notional) should be captured in the cost base;
- An appropriate valuation methodology needs to be developed to capture these assets.

We trust the above opinion is satisfactory to your requirements at this stage; should you require any further information or wish to discuss this issue further, please do not hesitate to contact us.

Yours sincerely
ERNST & YOUNG CORPORATE FINANCE LTD

Graeme Horsley
Director
Ernst & Young Corporate Finance Limited
john.schellekens@nz.ey.com

John Schellekens
Senior Manager
Ernst & Young Corporate Finance Limited
graeme.horsley@nz.ey.com