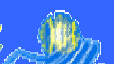


Submission to the Commerce Commission on Asset  
Valuation Methodologies for Electricity Line Businesses'  
System Fixed Assets

November 2002



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## Executive Summary

As the owner's representative of 100 percent shareholding in VECTOR Limited (and effectively over 98 percent of UnitedNetworks [UNL]), the Auckland Energy Consumer Trust (AECT) thought it appropriate to make a submission to the Commerce Commission in regard to its 1 October 2002 discussion paper entitled "Review of Asset Valuation Methodologies: Electricity Lines Businesses' System Fixed Assets" (the Valuation Discussion Paper).

The AECT is concerned that the valuation discussion paper did not make it clear what the intended purpose is of an appropriate valuation methodology apart from its current use in information disclosures. The AECT is concerned that the discussion about an "appropriate" asset valuation may bias the Commission's views towards more intrusive regulation.

Our submission is concerned from the point of view of representing our consumers and our beneficiaries as owners of a significant lines company. AECT plays a significant role in balancing ownership and consumer interests, as demonstrated through VECTOR's Statement of Corporate Intent (SCI).

The AECT is particularly conscious that consumers do not wish to see any degradation in the electricity distribution services in the Auckland and Wellington regions. Whilst consumers are concerned about price increases, we note that consumers are more interested in maintaining (and augmenting) the integrity of their electricity distribution networks. They also have an interest in fostering economic growth in their region.

Many of our consumers believe that infrastructural development is a key determinant in fostering economic growth. This also has been a focus of central government with renewed importance. However, service quality (including security of supply) can only be improved in the short term and long term for additional cost – hence there is a trade-off between price and security of supply.

AECT believes that the introduction of the threshold scheme and the revising of the ODV handbook as a result of the review undertaken Parsons Brinckerhoff (and including industry comments on the review), will be sufficient to address any current shortcomings in the regulatory framework.

The Commission should be wary about setting in motion a process that inexorably ends up with an intrusive regime either directly or indirectly; such a regime will lead to a situation less desirable than the present with regard to price and service. Instead, the Commission would be well advised in adopting a two tier approach in which the Commission's focus is on those line companies breaching the agreed thresholds (in the absence of good reasons) and devising a sensible method for control thereafter. We would support this new and improved form of regulation.

The AECT notes and fully supports the VECTOR/UNL submission, specifically:

- The Review has implied rather than actual regulatory purpose;

- Our consumers are interested in VECTOR providing a reliable and environmentally sustainable power supply to their homes and businesses and hence we fully support the fact that “the primary economic efficiency issue for lines businesses is getting the timing and type of investment right”<sup>1</sup>;
- Price and service thresholds do not require a prescribed valuation methodology;
- Rate of return regulation is to be avoided as the incentives for innovation, investment, and efficiency are removed;
- Valuations based on historic cost would not be feasible given the very inaccurate asset registers at the time of vesting and company amalgamations;
- The additional cost to our consumers from having to change the systems because of a change in the asset valuation method should be avoided;
- Valuations should be used solely for information disclosure purposes.

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<sup>1</sup> Excerpt from the Executive Summary of VECTOR/UNL submission

## Introduction

The Commerce Commission (the Commission) has invited interested parties to make submissions on its 1 October 2002 discussion paper entitled “Review of Asset Valuation Methodologies: Electricity Lines Businesses’ System Fixed Assets” (the Valuation Discussion Paper).

Based on an evaluation of the Valuation Discussion Paper, the Auckland Energy Consumer Trust (the AECT) considers that a submission to the Commission is warranted, in addition to the combined VECTOR/UNL submission, to outline to the Commission:

- What our consumers want and need at this stage in terms of price and service. We refer to this issue as willingness to pay for service and security; and
- What form of regulation is best to meet the above needs.

The AECT is confident in its assessment of consumer preferences for a number of reasons:

- It is an elected body with a representative mix of Trustees with diverse backgrounds and links to the community;
- AECT’s strong commitment to the needs of its beneficiaries and consumers as evidenced by the Statement of Corporate Intent (SCI) with VECTOR; and
- A customer centric VECTOR management that keeps the AECT fully informed on customer feedback regarding service and security issues.

For these reasons the AECT has a sound understanding about what the consumers of line services want now and in the medium term.

This submission is structured as follows:

- Who the AECT is;
- Consumer’s perspective - our understanding of the needs and wants of our consumers regarding the performance of VECTOR:
  - Security;
  - Service; and
  - Economic growth.
- What is the best regulatory regime to meet these needs;
- A discussion on the most appropriate valuation methodology given the regulatory intent and support for the VECTOR/UNL submission; and
- An appendix with a more detailed summary of the SCI.

# Our Perspective

## Introduction

The AECT supports the proposals for regulatory thresholds for price and service. A regulatory regime based on targeting those companies breaching the thresholds will ensure consumers get improved levels of service for a fair price.

## Background

Pursuant to the Energy Companies Act 1992, the ownership and control of the Auckland Electricity Power Board (AEPB) was transferred to a corporation, Mercury Energy (now VECTOR), with the shares being held by a community trust (the AECT) formed on 27 August 1993. The Deed forming the AECT, *inter alia*, provided for the allocation of shares in VECTOR (Mercury) to the Trustees, and set out the terms for the distribution of net income and capital from the trust's investments.

Income Beneficiaries are defined as customers taking and paying for electricity at a connection point to the electricity system in the original AEPB (i.e. VECTOR) region. As well as Income Beneficiaries, the AECT has Capital Beneficiaries – the local authorities in the original AEPB area (i.e. Auckland City Council, Manukau City Council, and Papakura District Council). Under the Terms of the Trust Deed they will receive the AECT's assets when it is wound up in 2073.

The AECT is made up of five Trustees who are elected by the income beneficiaries every 3 years. The process for the election and who can stand is also covered in the Deed of Trust. The Trustees, in accordance with VECTOR's Constitution, elect the directors of VECTOR.

The AECT effectively controls and owns 100 percent of the share capital of VECTOR Limited, which following the recent acquisition of UnitedNetworks is the largest lines company in New Zealand with over 600,000 customer connections covering the Auckland and Wellington metropolitan areas (after disposal of the Eastern region assets).

Responsible governance is achieved by having an explicit compact – the SCI. The SCI has been successfully balancing the interests of all stakeholders, particularly consumers.

## Balancing of Consumer Benefit with Financial Performance

Governance of VECTOR's behaviour is achieved through the SCI which sets out principles that VECTOR agrees to adhere to in its operations. These principles are agreed between the VECTOR's Board and the AECT. The SCI is reviewed on an annual basis.

The important point to note is that the purpose of the SCI is to strike a balance between the requirements of the respective consumers and stakeholders in VECTOR. The general consumer satisfaction in VECTOR's network area is evidence that the balance is about right.

The SCI covers a number of areas which are presented in detail in Appendix 1. In summary, they can be grouped as:

**Core Values**

- } Customer Service
- } Development
- } Shareholder Value
- } The Community

**Objectives**

- } Commercial
- } Social

The SCI is quite specific about what the AECT expects from VECTOR with regard to consumer needs and the beneficiary requirements. It ensures that service is not sacrificed for the sake of short term gains.

## Our Understanding of Consumer Preferences

The AECT is particularly conscious that consumers want to see continuing improvement in levels of service in the Auckland and Wellington regions. Whilst consumers are concerned about price increases, we note that consumers are more interested in the quality of service and supply and maintaining (and augmenting) the integrity of their electricity distribution networks. They also have an interest in fostering economic growth in their region. Many of our constituents believe that infrastructural development is a key determinant in fostering economic growth. This also has been a focus of central government with renewed importance being placed on infrastructure investment. However, service quality (including security of supply) can only be improved in the short term and long term for additional cost – hence there is a trade-off between price and security of supply.

### Security & Quality

The cost of non-supply varies from one consumer to another. However most studies<sup>2</sup> have shown that the impact is significant – to the extent that only a few hours of non-supply would have justified what might previously have been viewed as over-investment.

Another matter that our consumers are increasingly requiring is continual improvement in the quality of the energy supplied. This is particularly the case with consumers who have modern equipment sensitive to quality and whose products are often competing internationally.

### Service

Service has become a major issue for consumers as modern appliances and technology is much more responsive to differences in service, along with increases in consumer environmental demands. The Commission should steer clear of assuming the role of consumer in deciding what is the right amount of investment in the network – such as may

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<sup>2</sup> The analyses that set the value estimated depending on the consumer the cost of non-supply can vary between \$1.00 kWh and \$50.00 per kWh.

occur through a more intrusive regulatory regime as may be implied by a prescribed valuation methodology. The AECT uses the SCI to constantly challenge VECTOR to provide better levels of service.

We believe the Commission's aim is to maintain the incentive on companies to reduce costs by becoming more innovative rather than simply by sacrificing service. We support this, and are concerned by some of the discussion on asset valuation as it tends to suggest the Commission is thinking more broadly than price and service thresholds leaning towards a more intrusive regulatory regime, either directly or indirectly.

### **Economic Growth and the Importance of Infrastructure Investment**

The community is extremely concerned that jobs and income are put at risk because infrastructure investment does not occur. The AECT, of all owners, is well aware of the reaction by community to under-investment that ultimately ends in the degradation of supply. A country's reputation as a place to invest with a reliable electricity supply being a minimum requirement of most investors is also damaged. This is a very real danger if we have regulation focussed on the profits of line companies rather than price and service.

## **The Most Appropriate Regulatory Regime for our Consumers**

The regulatory purpose from a consumers' perspective has been succinctly summarised by the Government in the introduction to the Government Policy Statement (GPS)<sup>3</sup>. This is as follows:

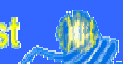
*The Government's overall objective is to ensure that electricity is delivered in an efficient, fair, reliable and environmentally sustainable manner to all classes of consumer. Industry arrangements should promote the satisfaction of consumers' electricity requirements in a manner which is least-cost to the economy as a whole and is consistent with sustainable development.*

The Commission is very familiar with the arguments against rate of return regulation and the AECT does not want to pointlessly repeat what has been stated in numerous submissions to the Commission and reinforced by the Commission in its publications. However, notwithstanding this, the AECT believes that it is well worth reiterating the following main problems with more intrusive regulation that is potentially implied by a prescribed valuation methodology:

- Intrusive regulation while well intentioned often has perverse effects – the most serious impact is reduced levels of needed investment ; and
- The direct costs of intrusive regulation are very high for the electricity industry including large regulatory agency costs (data problems, complexity of tariffs and size)

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<sup>3</sup> Government Policy Statement: Further Development of New Zealand's Electricity Industry – December 2000 (and further revised in February 2002)



involved in regulating the business and what industry spends justifying their charges to the regulator.

The direct and indirect costs of regulation are of importance to the AECT, as this burden is ultimately borne by the consumer. High costs of intrusive regulation will be seen as an unnecessary additional level of governance. Because of the AECT's concerns with the direct and indirect costs of regulation, the AECT strongly supports a price and service threshold regime and is concerned that more advocates against heavy handed regulation – such as rate of return regulation.

The AECT believes the intended introduction of the targeted threshold scheme and industry agreed changes to the ODV valuation method will improve the performance of underperforming line companies without the Commission having to do much more. The Commission should be careful not to proceed down a path that unavoidably ends up with a more intrusive regulatory regime, either directly or indirectly – which may be likely if the Commission is vague about how valuation is to be applied in the current regulatory proposals. Instead, the Commission would be well advised in adopting a two tier approach in which the Commission's focus is on targeting those line companies breaching the agreed thresholds (in the absence of good reasons) and devising a sensible method for control thereafter. We would support this modified regime.

## **Consistency with VECTOR/UNL Submission**

The AECT is aware of the submission being made by VECTOR/UNL to the Commission, and fully supports the stance. We note that there are no substantive differences between AECT and VECTOR in our respective submissions. For example, both submissions state:

- The Review has implied rather than actual regulatory purpose;
- Our consumers are interested in VECTOR providing a reliable and environmentally sustainable power supply to their homes and businesses and hence we fully support the fact that “the primary economic efficiency issue for lines businesses is getting the timing and type of investment right”<sup>4</sup>;
- Price and service thresholds do not require a prescribed valuation methodology; and
- Rate of return regulation is to be avoided as the incentives for innovation, investment, and efficiency are removed.

In addition, we support the points made in VECTOR/UNL submission that if asset valuations are to be used:

- Valuations based on historic cost would not be feasible given the very inaccurate asset registers at the time of vesting and later from company amalgamations;
- The additional cost to our consumers from having to change the systems because of a change in the asset valuation method; and
- Valuations should be used solely for information disclosure purposes.

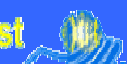
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<sup>4</sup> Excerpt from the Executive Summary of VECTOR/UNL submission

## Appendix 1

<i>Core Values</i>	
<b>Customer Service</b>	<ul style="list-style-type: none"> <li>▪ Being responsive to customers' needs, and</li> <li>▪ Providing customers quality network services, with reliability that consistently exceeds their expectations</li> </ul>
<b>Development</b>	<ul style="list-style-type: none"> <li>▪ Seeking technological innovation to optimise our performance</li> <li>▪ Using energy efficiency as an alternative to network investment</li> </ul>
<b>Shareholder Value</b>	<ul style="list-style-type: none"> <li>▪ Maximising returns to shareholders, while minimizing prices to customer through efficient operating performance</li> </ul>
<b>The Community</b>	<ul style="list-style-type: none"> <li>▪ Operating to the spirit and letter of regulations for its network businesses, and behave as a respected member of the community</li> </ul>

<i>Objectives</i>	
<b>Commercial</b>	<p>To maximize shareholder value, VECTOR will:</p> <ul style="list-style-type: none"> <li>▪ Optimise our operational costs, and access operational synergies with other network businesses while maintaining security and quality standards</li> <li>▪ Undertake investments which will have a return at least equal to VECTOR's cost of capital for that investment, and</li> <li>▪ Actively manage risk, limiting the exposure of the company, customers and public within prudent levels</li> </ul>
<b>Security of Supply</b>	<ul style="list-style-type: none"> <li>▪ Maintain, upgrade and expand its networks as necessary to ensure a high reliability of supply to customers</li> <li>▪ Deliver security, and measure its security planning against international practice</li> </ul>
<b>Pricing</b>	<ul style="list-style-type: none"> <li>▪ Ensure sustainability of the business</li> <li>▪ Introduce differentiated zones across networks to allow pricing and service levels to reflect over time the requirements and characteristics of different customer groups, and the true cost of providing the services to them that they require</li> </ul>



<b>Objectives</b>	
<b>Social and Community</b>	<ul style="list-style-type: none"> <li>▪ Balance the requirements for financial profitability responsibly with our public service requirements of service and safety</li> </ul>
<b>Financial Performance</b>	<p>Targets for each financial year covering:</p> <ul style="list-style-type: none"> <li>▪ Ratio of Earnings Before Interest and Tax to Total Assets</li> <li>▪ Ratio of Net Profit After Tax to Shareholders' Funds</li> </ul>
<b>Dividends</b>	<p>VECTOR will distribute funds surplus to the investment and operating requirements defined in this Statement of Corporate Intent, which include:</p> <ul style="list-style-type: none"> <li>▪ Funding the Overhead Improvement Programme</li> <li>▪ Maintaining the integrity of the network</li> <li>▪ Enabling the development of VECTOR</li> </ul> <p><i>subject to</i></p> <ul style="list-style-type: none"> <li>▪ Solvency requirements of the Companies Act 1993, and</li> <li>▪ Ensuring satisfaction of the capital structure condition above</li> </ul>
<b>Operational Performance</b>	<ul style="list-style-type: none"> <li>▪ SAIDI average minutes without supply per customer (excluding transmission interruptions) or less</li> <li>▪ Customers with fault frequency within our published standards</li> </ul>