



**Response to the Commerce Commission’s Discussion Paper
“Review of Asset Valuation Methodologies:
Electricity Lines Businesses’ System Fixed Assets”
by
Dunedin Electricity**

Dunedin Electricity Limited (DE) is particularly well placed to comment on various issues relating to asset valuation, both because it has purchased a network at a price in excess of the “MED Handbook ODV” (hereafter referred to as the MEDODV) and because it is the first distribution asset owner to undertake a revaluation of its distribution assets under FRS-3.

The Purpose of Valuations

The Discussion Paper does not make clear the purpose of regulatory asset valuations. Having been involved in many valuation exercises involving electricity lines businesses – from both a regulatory and commercial perspective – DE recommends broad alignment between regulatory and commercial valuation methodologies. Our stance is that economic valuations should be used. These valuations are based on expected future cash flows and have been externally corroborated, in both Australia and New Zealand, through numerous competitive transactions involving acquisitions of electricity lines businesses.

We are aware that the Commerce Commission (the Commission) is reluctant to use DCF valuation methodologies as they are earnings based and would be tautological to the extent that they are used for setting prices. However, previously, the Commission has implied a preference for a regulatory regime involving efficiency and quality thresholds. DE recommends that the Commission adopt this approach for the regulatory framework in New Zealand. If this formed the basis of the regulatory regime, then DE argues that asset values would be used for information disclosure purposes and are unlikely to be used for pricing purposes. Clearly, this outcome would be favourably disposed towards the use of economic values – for instance:

- Economic values could be used for information disclosure purposes as they are in fact more relevant and comparable than (say) historic cost valuations.
- There is no tautology as the efficiency thresholds, rather than earnings based economic values, are used where it proves necessary to control prices.

However, should the Commission decide to use asset values for setting prices and/or profitability thresholds, then DE’s stance is that ODV is the most appropriate valuation methodology. By way of clarification, DE is not advocating this approach to regulation. However, in our view, ODV is the second best valuation methodology as it draws analogies to the competitive market through DRC and optimisation.

If ODV’s were to be used by the Commission, then DE has significant residual concerns in relation to the ODV Handbook. Significant work is required to address flaws in the practical application of the ODV methodology.

The Regulatory and Business Valuation Dichotomy

We have previously stated that economic (i.e. commercial) values are the appropriate methodology for regulatory valuations. However, in the absence of adopting economic valuations the Commission should not be surprised if commercial and regulatory values differ. As in these circumstances the different valuations would be for different purposes, it is most likely that the valuation outcomes would differ. We provide further comments on the differences in our responses to the Commission's questions (refer to Question 33).

In our view, it appears from the Discussion Paper that the Commission believes regulatory and economic/commercial valuations should be aligned. Clearly this is not likely to be the case, as the Commission is referring to the likes of ODV valuations instead of economic valuations.

For example, in the Commission's review of FRS-3, the Commission has noted that regulatory valuations and accounting valuations are for different purposes.

- i.e. Regulatory valuations are required for purposes of measuring rates of profit and for determining prices or revenue controls.

However, the Commission tends to view FRS-3 from a regulatory perspective, and as such may have misinterpreted its actual application – for example:

- The Commission states that FRS-3 provides two valuation options for the valuation of line company assets – depreciated historic cost or ODRC.
- In referring to ODRC, the Commission does not differentiate between “accounting optimisations” and “regulatory optimisations”.
- Regulatory ODRC is not an acceptable accounting measure under FRS-3.
- The paper “muddles” the treatment of accumulated depreciation when revaluations occur.
- Also, the Commission's analysis seems wrong in relation to impairment write-downs for revalued assets.

Most importantly, however, the Commission has ignored the application of the DCF methodology pursuant to FRS-3. Economic valuations such as DCF provide the linkage in the long term between revenue requirements and value. DCF methodologies are therefore perfectly acceptable regulatory measures where prices are set exogenously – such as through efficiency thresholds.

Commerce Commission Discussion Paper

DE has not attempted to answer all of the questions raised by the Commission in the discussion paper. Rather, the focus of our response has been to comment broadly on the matters that raise significant issues for DE. We commence with the issue that has

raised the most fundamental questions about the light handed regulatory vision that New Zealand has pursued.

Question 33:

What could explain the evidence of transactions of electricity lines businesses' system fixed assets greater than their ODV? How important are current and intangible assets in explaining the evidence?

DE Response:

There are widespread misconceptions over this issue and the Commission's comments in paragraphs 5.16 to 5.18 and 10.40 to 10.41, and Question 85, mirror questions by its Australian counterpart (the ACCC) on the evidence of transactions involving electricity lines companies.

In its Draft Statement of Principles for the Regulation of Transmission Revenues, the ACCC¹ suggests that DORC² should set an upper limit on an asset's value for regulatory purposes. The ACCC suggest that DORC attempts to measure...

“the maximum price that a firm would be prepared to pay for ‘second hand’ assets with their remaining service potential, higher operating costs, and (old) technology – given the alternative of installing new assets which embody the latest technology and which generally have lower operating costs, and which will have greater remaining service potential. Therefore, if prices reflect a value that is in excess of DORC, then users would be better off if the existing system were scrapped and replaced by new assets. Similarly, if assets are sold for prices above the DORC valuation, then this implies that scarce investment funds are being inefficiently applied: in this case, it would have been a more efficient use of investment funds for the existing assets to be scrapped and a duplicate system installed.”

In this context the ACCC has implied that businesses that paid more than ODRC at the time of an asset sale should not be allowed to recover their costs.³ This stance has been criticised, by both the industry and the investment community, on the grounds that there is no evidence in either theory or practice to suggest that ODRC and market values should converge.

“Our view is that the premise that ODRC and market values should align is fundamentally flawed. The ODRC of an asset is essentially an accounting value adjusted for depreciation, capital expenditure, and inflation. The market value of a regulated asset is the discounted income stream that investors expect to earn over the life of the asset. The market value is determined by expectations on efficiency gains and outperforming incentives. Without perfect

¹ Australian Competition and Consumer Commission

² DORC, or ODRC is similar to ODV and is intended to represent the maximum price that a new entrant would be willing to pay for existing assets rather than purchase new assets.

³ Rod Shogren, Commissioner, ACCC, commenting at the Asset Valuation Forum, Melbourne, 16 June 2000. (As quoted by Hastings Fund Management Limited in Epic Energy's response to Draft Decision (Access Arrangement for Moomba to Adelaide Pipeline) – 10 October 2000; Appendix 3; pp 6-7).

foresight of all future regulatory decisions, it is impossible for businesses and regulators to have the same view about asset values.”⁴

Further, the regulators have been accused of “*perversely prevailing upon the market and attempting to force an alignment of market values with regulated asset bases*”.⁵

In DE’s view, this debate has been unnecessary and has been fuelled by myopic vision. Both the regulators and the investment community have been observing the “world” from the perspective of their own “purpose driven” asset valuation methodologies. From our perspective;

- a) the regulator is correct that properly derived ODV (or ODRC) should reflect the maximum value of the assets – based on replacement costs at a point in time. However, this is a static measure, and simply values the assets from the viewpoint of current replacement costs, current load (including permitted short term load forecasts), and current optimisation.
- b) the investor is also correct that values in excess of ODV may be appropriate. The following non-exhaustive list of reasons apply:
 - i. Business valuations will take into account growth in the utilisation of existing assets – possibly together with other growth opportunities that may involve future investment in assets or future other uses of existing assets⁶. In accounting parlance, some of these growth considerations⁷ would be generically described as “goodwill”. However, most growth prospects are optimised out of “static” regulatory valuations.
 - ii. Inherent in the business valuations may be a judgement call that future regulatory rate setting will be more conducive to investment – particularly if the need for new infrastructural investment is apparent. Whilst this is a judgement call, DE notes that the Competition Commission in the UK, accepted an appeal by water companies that price limits imposed by the water regulator (OFWAT) in their final determination did not enable the companies to finance the proper carrying out of their functions. In future pricing reviews, OFWAT will take into account the issues raised by the Competition Commission.⁸
 - iii. Static valuation is based on idealistic circumstances. Rarely in practice would these ideal circumstances exist. For example,

⁴ Comments from Hastings Funds Management Limited to the ACCC in relation to Epic Energy’s proposed access arrangement for the Moomba to Adelaide pipeline. Refer to Epic Energy’s response to Draft Decision (Access Arrangement for Moomba to Adelaide Pipeline) – 10 October 2000; Appendix 3; pp 6-7.

⁵ *ibid.*

⁶ Appendix 1 includes a photo of broadband radio communication equipment located on a quite ordinary power pole, providing coverage of most of the Dunedin CBD. Ability to “co-locate” such equipment without detectable environmental presence has real if uncertain future value.

⁷ i.e. opportunities related to assets that do not currently exist

⁸ Refer to: (i) Competition Commission, “Mid Kent Water Inquiry Issues Statement”; 17 April 2000, and (ii) Annual Report 2000-01 of the Director General of Water Services (OFWAT) p8.

*“If technology is rapidly changing then there can be **value** to the new firm of waiting for future developments. This can affect the willingness-to-pay for existing assets relative to new assets. ...the purchase of existing assets might allow the firm to cover its short term obligations while maintaining an **option** to upgrade to improved technology when it becomes available.”⁹*

Given the sophisticated stochastic modelling techniques now available (e.g. to determine the value of Real Options in addition to traditional discounted cash flows) there is little surprise in the investment community that commercial valuations tend to exceed regulatory valuations.

- iv. Synergies and efficiencies are expected to arise from the acquisition transaction.
- v. Other property rights (such as resource consents, and rights of way).

Having commented on the theoretical aspects, we turn to the evidence. All sales of distribution assets in New Zealand since the introduction of the ODV concept have occurred above MEDODV and this has led to the incorrect perception by some that purchasers must have included an expectation of future excess profits. It is not that simple.

As an illustration of the complexity, consider the valuation of wooden power poles. The MEDODV handbook says that these have a life of 45 years. DE has very reliable data on the installation dates, and hence ages, of existing wood poles – data recently audited by the Commission. If the MEDODV handbook is correct then DE should be replacing approximately 1300 such poles per annum. In fact, over the past decade pole replacements have averaged approximately 400 per annum. Over this same period the average distribution reliability achieved has remained essentially constant – demonstrating that maintenance standards and network quality have not been sacrificed.¹⁰ The inescapable conclusion is that the MEDODV handbook life is wrong – it is far too short.

An even greater absurdity is the requirement that zone substation buildings have lives no greater than 40 years, when equipment inside them has longer lives. No sane engineer would design a building to be replaced before the equipment it houses. Very few zone substation sites will *ever* be abandoned and many such buildings provide a more essential service to the community today than they did when built up to 80 years ago.

We observe this same pattern across a range of plant, with the result that actual plant replacement is occurring at significantly longer average intervals than the MEDODV handbook says are to be used. The result is that much more of the Replacement Cost remains than the MEDODV allows – the assets have a value significantly above MEDODV.

⁹ King, S.P; “Report on the construction of DORC from ORC”; 14 February 2001; pp 6-7

¹⁰ Appendix 1 – chart of DE network performance (SAIDI)

The next factor is the MEDODV handbook replacement costs – which do not recognise all the costs that would need to be capitalised in replacing the network. We are told that the handbook replacement costs represent “green field” construction costs, in an attempt to simulate the cost today if the network was to be built today, but in the same way that it was originally built over prior decades. The simple fact is that replacement of today’s assets cannot possibly occur at green field costs, because they cannot be replaced under green field conditions. The assets must be replaced while keeping power on (or power interruptions minimised), while working around adjacent live plant and pedestrian & road traffic, and while breaking and reinstating roads, footpaths, gardens, etc. Economic valuations which discounted future costs and revenues will “correctly” determine the value of the assets by taking into account the real future costs of replacing them. The MEDODV does not.

In the above comments on asset lives and asset replacement costs we did not comment on variability. The MEDODV handbook allows little variability in either life or replacement cost, and the recent MEDODV validation exercise resulted in recommendations for further reduction of judgement in regard to substation replacement costs. Returning to wooden power poles, the degree of deterioration over time will clearly vary between (for example) dry geographic areas and wet, hot areas, yet no recognition of variable asset lives is allowed. We are unable to comment on whether the MEDODV handbook lives represent appropriate averages for such variability across the 27 distribution businesses. We do know that they do not approach reality for DE’s assets.

These “weaknesses” in ODV methodology are not fatal to the ODV concept, but they do result in the MEDODV understating real value. Indeed, precisely because the MEDODV provides such an average for lives and costs, it might be the most appropriate component of any regulatory yardstick, PROVIDING the purpose is only to establish a threshold beyond which a full investigation will be conducted.

Finally, when comparisons between acquisition values and ODV are made, it is important that we compare like with like. The ODV values regulated assets, and should therefore be compared with the purchase price for the same regulated assets. Historically, many line business acquisition transactions have involved other business activities – such as a significant contracting business, undertaking electrical construction and maintenance activities for the network and often for other clients, and/or other assets or businesses. Such businesses were generally performing well below potential under their old owner, both because of poor internal management and because of failure to identify real, and often “ready to hand”, external opportunities. External commentators on these transactions were not well-enough informed to identify or separate these components from the total price paid, while the purchaser was obviously reluctant to disclose its strategy to competitors for subsequent acquisitions.

Having been involved in acquisitions involving electricity lines businesses, DE can state categorically that valuations in excess of MEDODV are not “challenges” to the regulatory authorities. Neither are they evidence that the light-handed regulatory regime in New Zealand is not working.

In summary, DE considers that there are legitimate reasons for business valuations in excess of MEDODV. This is simply because MEDODV is not a business/economic valuation of expected cash flows over time. In part, some of this additional value may relate to intangible assets, but from DE's experience the intangible asset component is not the most significant difference between regulatory valuations and business valuations.

Having commented on the misconceptions about transaction evidence, we move to the issue of whether regulatory and accounting valuations should or will equate.

Question 28:

What relevance does FRS-3, or any other standards and policies, have for the Commission's criteria for evaluating valuation methodologies?

DE Response:

Economic theory on valuation generally expresses the view that there is one relevant value for an item – related to the best use for that item. Anything else is a shadow valuation. However, special purpose valuations (such as for regulation and taxation purposes) are exceptions.

Sections 4.50 to 4.52, and 4.55 of the Commission's discussion paper suggest that the Commission is attempting to connect accounting/commercial valuations (e.g. FRS-3) with regulatory valuations.

DE rejects this approach. Across regulatory jurisdictions the primary purpose of regulatory asset valuations is generally to provide a basis for establishing rates of return – either on an *ex-ante* basis for setting revenue requirements, or on an *ex-post* basis for assessing performance. Other regulatory purposes include information disclosure so that others can assess performance and the allocation of revenue recovery to individual tariff classes. By their very nature, regulatory valuations are a static measure – relating only to a particular set of circumstances at a particular point in time.

For example, an asset valuation using ODV will reflect the utilisation adjusted value of the asset(s) in their current use for servicing current customer requirements. This regulatory value neither portends fair value, nor suggests what someone else may be prepared to pay for the assets.

Financial reporting values are different. Pursuant to FRS-3 they are required to reflect fair value – which is the arm's length value that a willing buyer and a willing seller will agree for the asset at its best and highest use. For a distribution network, the highest and best use is arguably when the individual assets/components are included as integral parts of the network, and the network as a whole becomes the “asset” for valuation purposes.

Such accounting valuations are dynamic measures. The value relates to the future cash flows – which may or may not have a strong correlation with replacement costs.

We therefore note that, under FRS-3, ODV is not an acceptable valuation methodology for financial reporting purposes. However, we contend that ODV is an appropriate valuation methodology for regulatory purposes.

The essential point is that regulatory and business valuations need not be the same. The Commission's choice of asset valuation methodology need not be connected to accounting valuations. Instead the Commission must ensure that the appropriate

incentives for investment, innovation, and efficiency that should underpin New Zealand's regulatory regime are not compromised by the inappropriate use or choice of asset valuation methodology.

To this extent, the Commission's question validly asks what relevance FRS-3 has for the Commission's evaluation criteria. In this regard, it is clear that FRS-3 is embodying concepts of comparability and relevancy. DE would encourage the Commission to consider these criteria in their evaluation of asset valuation methodologies. DE does not regard historic cost valuations to be comparable over time, or across entities. Similarly, historic cost valuations have no ongoing relevance to competitive market pricing. For this reason, DE recommends the use of replacement cost methodologies for regulatory purposes.

Question 20:
How can accounting depreciation best be kept in line with economic depreciation?

DE Response:

It is clear that accounting standard setters have moved to align financial statement with economic reality. However, it is overly simplistic to expect that accounting depreciation should follow regulatory depreciation or vice versa.

At first sight, one would expect accounting depreciation to be aligned with economic depreciation. For instance, the accounting principles are:

- Depreciation is the measure of consumption of the economic benefits embodied in an asset whether arising from its use, the passing of time, or obsolescence (FRS-3 para 4.22)
- An asset's depreciation method must be reviewed annually. If there has been a change in the asset's useful life or in the expected pattern of consumption of the asset's economic benefits, the depreciation method must be changed to reflect that pattern (FRS-3 paras 8.16, 8.19)
- If the value of the asset is less than its carrying amount, the item must be written down, and a charge made against the revenue in the current period (FRS-3 para 9.10, 9.11)

In reality, however, this question is not as simple as it first appears. In all cases the annual quantum of depreciation should match any reduction in the value of the underlying asset (whether that is initial cost, depreciated historic cost, or a modified value). The other factor influencing the outcome is the expectation of the asset's useful life.

The two areas of difference are likely to be:

- a) the asset valuation methodology
- b) the treatment of unanticipated "impairment" (i.e. stranded assets)

In relation to the asset valuation methodologies we do not expect the Commission's regulatory valuation of assets to align with business valuations. We have covered this point in greater detail in our response to Question 33. Whilst acknowledging shortfalls (e.g. economic lives) in the ODV Handbook, DE considers that ODV is appropriate as a "second best" asset valuation methodology for the Commission to adopt for regulatory purposes. However, pursuant to FRS-3, DE will adopt fair values (such as may be provided by a DCF methodology) for financial reporting purposes.

In relation to unanticipated impairment, the question is whether any revenue/recovery should be associated with the impairment. We note that this is an entirely different question to whether the impairment is recognised as a charge for the period. DE contends that any economic depreciation due to stranded assets would also be treated

as impairment for accounting purposes – and a “depreciation like” charge will be made against revenue.

However, the Commission appears to be concerned with the appropriateness of “covering” the risk of stranded assets with an economic depreciation methodology. DE recognises that the efficacy of such an approach is an entirely separate, and broad, topic – covering issues such as the risks and rewards of ownership, consumer complicity in the investment decision, and incentives to keep assets in service. DE does not propose to address this topic any further in this report.

DE also notes that the Commission is concerned with the converse position – where assets may be depreciated before the end of their economic lives. Whilst the Commission sought comments on this in Question 21, for convenience DE notes that the Commission may look to FRS-3 for guidance on revaluing assets, changing useful lives etc. In essence the Commission appears looking for a mechanism to spread depreciation charges to the “very end” of the asset’s practical usefulness – so as to retain the “depreciation recovery” incentive for the asset owner to keep the assets in service. There are many mechanisms that the Commission could adopt to achieve this. However, the most obvious would appear to be periodic recalibrations of MEDODV’s and the MEDODV Handbook.

Question 29:

What other accounting policies or practices, if any, are relevant to the review?

DE Response:

DE rejects connecting financial reporting valuations with regulatory valuations per se. However, if the Commission were to decide that asset valuations are appropriate for measuring rates of return, then DE argues that a broad review of accounting policies and practices are necessary to determine what may appropriately be included or excluded from the regulatory base.

For example, firstly it may be appropriate for the Commission to consider including certain intangible assets in the regulatory asset base. Similar moves were resisted by financial standard setters for some time, but in certain cases (particularly for purchased goodwill), intangible assets are now legitimately recognised in financial accounts. DE's point is that the determinant for including assets in the regulatory asset base should not be based solely on the assets tangibility. Instead, assets (tangible or otherwise) should be included if they are "used and useful" in the reticulation of electricity. Secondly, as earnings are appropriate for measuring rates of return, the review should determine what adjustments to accounting earnings are required to reflect the regulatory intent – for example, adjustments for accruals and deferrals may be necessary.

In addition, DE considers that the review of regulatory valuation methodologies should take into account the purpose for which asset valuations are to be used.

In section 4.49 the Commission cites that asset valuations are required, for example, for the purposes of measuring rates of profit, or for determining price or revenue controls.

The Commission's evaluation criteria (for the valuation methodology) seem to consist of:

- Allocative efficiency
- Productive efficiency
- Dynamic Efficiency
- The ability to signal excessive profits
- Cost effectiveness

However, DE would argue that the evaluation criteria should be contextual – based on any purpose to which the asset valuations are likely to be used and the regulatory incentives that need to be achieved. For example, if the valuation methodology were to be used solely for Information Disclosure purposes (perhaps so that other interested parties may measure rates of profit), then comparability and cost effectiveness may be the paramount considerations. If, however, asset valuations were to be used in regulation of prices (which, for the purposes of clarification DE suggests would be counterproductive unless used solely as a control mechanism), then the Commission should broaden the evaluation criteria to include:

- Non discrimination
- Equity
- Transparency
- Price stability

These additional principles have been used in Australia for the regulation of network prices, but are nonetheless important in New Zealand. For instance, the use of these principles in assessing asset valuation methodologies may lead to the following conclusions:

- a) In the interests of non-discrimination historic costs should not be used as a valuation methodology for regulatory purposes. Historic costs tend not to be comparable from one business to another, or over time.
- b) In the interests of price stability, historic costs should be avoided. Prices will tend to jump (especially following periods of inflation) when significant assets are replaced.
- c) In the interests of price stability and equity, we would suggest that rates of profit should be measured over a long time period (i.e. more than a single year). This is to be consistent with commercial reality where profitability fluctuates through business cycles, and overall returns equivalent to WACC are only achieved over the long term.

Question 31:

Should the regulatory asset valuation methodology include prescribed accounting policies, such as in relation to capitalisation and depreciation?

DE Response:

Many of the accounting principles embodied in FRS-3 have been well thought out and are therefore logical and internally consistent. Whilst DE does not seek to connect regulatory asset valuations with financial reporting values, it is clear that the logic behind the FRS-3 treatment of depreciation and capitalisation will auger well for any regulatory valuation methodology.

Essentially this becomes a question of the detail behind the methodology. Whilst accounting and regulatory methodologies may differ at a high level, at the technical/operational level there is no reason for the details and mechanics to be different *per se*.

The Commission should query what incentives (perverse or otherwise) there may be for regulated electricity lines businesses to (mis)classify expenditure as either operating expenditure or capital expenditure. Presumably, under rate of return regulation the incentives would relate to an inherent preference for either a return of capital¹¹, or a return on capital. In a perfectly efficient context, there should not be any bias. However, if the regulated return is too low (say below WACC), then the lines company would be incentivised to treat expenditure as operating expenditure and recover the capital immediately through the revenue requirement.

The point that is being made here is that the Commission could prescribe policies relating capitalising expenditure. However, these policies will create tensions and there will be a risk of “evasion” or non-compliance if the regulatory regime has an inefficient design.

¹¹ In this context capital is defined broadly – and refers to working capital such as would be used for operating expenditure.

Question 69:

What would be the implementation and operational implications for accounting systems and processes if regulatory asset valuation required an historic cost-based approach (DHC or DIHC)? How could the implementation issues be satisfactorily addressed and in what time frame?

DE Response:

The implications for (regulatory) accounting systems and processes will depend on several factors - including:

- whether indexation and/or optimisation is required; and
- whether the Commission is to differentiate between opening assets and future assets.

As the Commission's question deals with historic cost valuation systems, we note that the regulatory purpose for asset valuations will have little impact on the design of the system¹². One would expect original cost and (accumulated) depreciation to be the important information – irrespective of whether the asset valuations are to be used for information disclosure purposes, for pricing/profitability threshold purposes, or for control purposes. However, more complexity will be introduced into the design and implementation of systems if indexation and/or optimisation were to be required.

DE would see significant implementation implications across the industry if all assets were to be recorded on an historic cost basis. This is due to the dearth of reliable historic cost information relating to older (pre vesting) assets. On the other hand, DE considers that it would be relatively easy to maintain appropriate historic cost records for all future assets. However, to achieve this, it may be necessary to deem the existing ODV's as opening historic costs. Whilst this may be a pragmatic solution, DE questions the logic of a split valuation approach. Such moves are likely to create non-comparability across network regions – particularly as existing asset ages differ from network to network.

Providing some accommodation can be obtained for opening historic costs, DE believes that appropriate historic cost systems could be implemented within 6 months.

¹² Whereas, if replacement cost valuations were required, depreciation calculations may be less relevant for information disclosure purposes, but are entirely relevant for other purposes – such as pricing.

Question 72:

In respect of historic cost-based asset valuation approaches, could reliance on accounting standards (particularly FRS-3) and conventions be relied upon to ensure consistency or comparability of valuations?

DE Response:

Because FRS-3 provides two main options for recording asset values, it cannot be relied on to provide consistent and comparable valuations. The options (and sub-options) provided by FRS-3 are as follows:

a) Historic cost valuations

“An item of property, plant and equipment that meets the asset recognition criteria must be recognised in the statement of financial position ... must initially be recognised at its cost, which includes costs directly attributable to bringing the item to working condition for its intended use” (FRS-3 paras 5.1 and 5.3)

b) Revalued/modified valuations

“Subsequent to initial recognition, an item of property, plant and equipment may be revalued ... to fair value ...” (FRS-3 para 7.1)

“Where the fair value of an asset is able to be determined by reference to the **price in an active market** for the same asset or a similar asset, the fair value of the asset is determined using this information. Where the fair value of an asset is not able to be determined in this manner, the fair value of the asset is determined using other market based evidence, such as **discounted cash flow calculation** using market estimates of the cash flows able to be generated by the asset and a market-based discount rate. Where fair value of the asset is not able to be reliably determined using market based evidence, **depreciated replacement cost** is considered to be the most appropriate basis for determination of fair value. This situation will usually only arise where an asset is specialised or the only transaction price evidence arises in a monopoly context.”

Our first point is that initial cost valuations are not always comparable under FRS-3. There are several reasons for this:

- The reported initial cost of similar items will usually differ with the passage of time.
- Initial costs are entity specific. For example, the initial costs of assets for an entity will change if that entity is acquired by another entity. For the acquiring entity, their initial cost for the (acquired) assets will reflect the fair price paid for them.

Our second point is that revalued assets should be, but may not always be, comparable under FRS-3. DE considers that the revaluation of assets pursuant to FRS-3 should be undertaken in a comparable way – providing valuations that are economically consistent and defensible. However, whilst DE holds a firm view that FRS-3 requires electricity network assets to be valued using a DCF methodology, we are aware that some lines companies may adopt a DRC valuation methodology¹³. To the extent that this occurs, assets revalued pursuant to FRS-3 will not be comparable.

FRS-3, in conjunction with the Statement of Concepts¹⁴, provides a clear indication that the purpose of revaluation is to provide comparability by valuing assets at their fair value. Fair value definitions include:

“the amount for which an asset could be exchanged ...between knowledgeable, willing parties in an arm’s length transaction...” (FRS-3 para 4.23)

“...determined by reference to its highest and best use, that is, the most probable use of the asset that is physically possible, appropriately justified, legally permissible, financially feasible and which results in the highest value.” (FRS-3 para 4.25)

There should only be one “fair value”, and that is the market driven, comparable, and economically defensible value determined using discounted cash flows. Since the promulgation of FRS-3 DE has pioneered this approach, and the approach has been approved by DE’s Auditors.

Our third point is that there is no compulsion for an entity to revalue (although there are requirements to write down values to recognise impairment). Accordingly, under FRS-3, there is risk that reported asset valuations will not be comparable due to differing approaches to revaluation.

In summary, in terms of historic cost valuation approaches, FRS-3 cannot be relied on to provide comparable asset valuations. Whilst indexation may help in providing comparability across time, the index would have to be specific to that asset class to avoid introducing other “noise”. However, if specific indexation were applied, then this is tantamount to undertaking an asset revaluation.

On the other hand, providing DCF valuations were consistently applied by the industry, revalued assets pursuant to FRS-3 could be relied on to provide comparable asset valuations.

¹³ For convenience as DRC is closely related to ODV.

¹⁴ Statement of Concepts for General Purpose Financial Reporting - ICANZ

Appendix 1

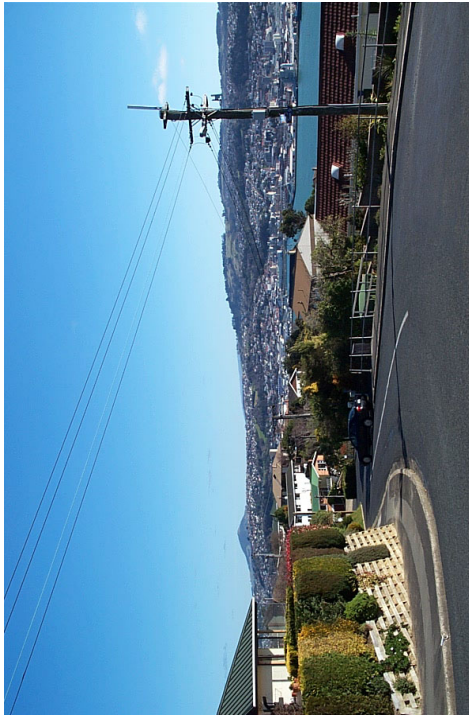


Fig 1. Overview, showing Broadband radio equipment serving Dunedin CBD



Fig. 2 Equipment detail

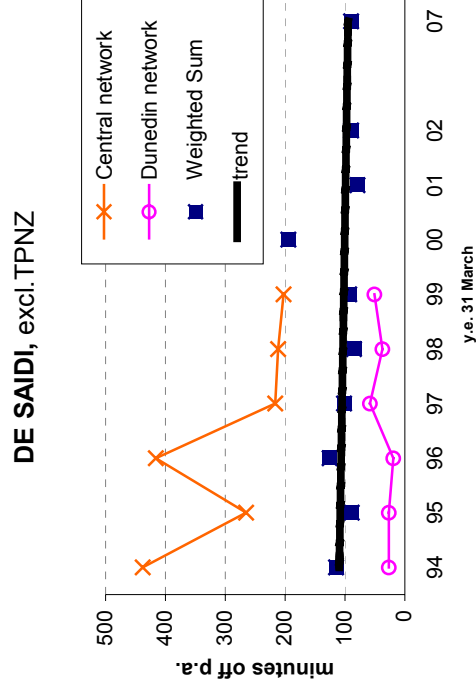


Fig 3 Graph showing DE (+CEL) SAIDI maintained at 100 minutes per annum, 1994-2007