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Submission on Commerce Discussion Paper on Review of Asset Valuation Methodologies

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GENERAL COMMENTS

Overview

The electricity distribution industry has consistently worked hard to support the intent of regulatory policy initiatives, for example by immediately exiting the energy business when the Electricity Industry Reform Act 1998 signaled that this would be required by 2004, and by moving constructively to respond to *Government Policy Statement* initiatives. We see value in maintaining this cooperative, responsive approach, rather than drifting into the adversarial process-focused relationships that characterise the industry/regulator interface in jurisdictions such as the US, the UK and Australia.

In designing the successor to the current light handed regulatory regime, and in considering the way valuation data can be incorporated into it, we recommend that the Commission give attention to preserving this relationship. There is quite comprehensive data, outlined below, demonstrating that New Zealand electricity consumers are benefiting from the flexibility and innovation that are associated with concentrating on achieving policy outcomes rather than becoming fixated with industry inputs.

The three key themes of our submission are therefore:

- (a) that the threshold regime be designed without a central focus on valuation, and that any extension of the role of valuation beyond information disclosure not be considered until the core threshold design has been established;
- (b) that no case exists for a change in valuation methodologies from ODV, which is appropriate for comparative disclosures;
- (c) that falls in real line charges and improved service levels have been achieved in a situation where the scope for controlling input costs is limited. This reflects the current focus of the lines industry on controlling expenditure by optimizing asset investment and utilization. A shift to a methodology that used the historical sequencing of asset investments, rather than their current utility, would be unlikely to deliver comparable consumer benefits over time.

Guiding Principles

With the above points in mind we recommend that the Commission apply the following short list of principles in its evaluation of regulated valuation methodologies.

1. There is a need for correct sequencing and smooth linkages between the various elements of electricity regulation that are now emerging. These are:
 - The price control thresholds regime.
 - The valuation methodology, if any.
 - The Government Policy Statement directives that are, effectively, imposed on the industry by the threat of regulation.
 - The Electricity Governance Board rules, and the EGB's industry governance role.
 - Various new legislative or governmental requirements (including a new 'Powersafe' electricity safety regime, inclusion of electricity line services in the Consumer Guarantees legislation, whatever emerges from the current governmental review of 'trees and powerlines' – which has implications for service quality, and requirements in the pending new Local Government legislation for participation in local planning processes).
2. The industry, and especially power consumers and other clients, will be best served by a regime that is simple both to apply and to understand, that is inexpensive to administer, and that identifies and meets clear objectives. (The existing information disclosure rules relating to valuation seem to be working reasonably well and to conform with these criteria.)
3. The investment climate impacts and wider societal costs of disrupting the lines industry should be weighed carefully against demonstrable benefits before a decision is made.
4. It is also desirable to have a regime that does not disrupt established time series and data bases, i.e. one that is built on existing foundations unless there is a clear and useful reason for abandoning those foundations.

Especially with the first of these principles in mind we recommend that an opportunity be provided for the industry to comment on the overall regulatory package that emerges from the various Commission work streams before this is implemented.

Sequencing

The sequencing of the Commission's work on valuation and thresholds is not providing an opportunity for our members to engage constructively with policy development. The asset valuation discussion paper has been issued, and is being processed, before the basics of the thresholds regime (and of its supporting information requirements) have been defined. We recognise that the Commission has a legislative commitment (Part 4A, Subpart 4 of the Commerce Amendment Act [No 2] 2001) to "...carry out a review of valuation methodologies

for line business system fixed assets as soon as practicable.” Nevertheless, we note that this task is placed after the primary “Subpart1” requirement in the Act to develop thresholds for the declaration of price control. From our perspective it is imperative to have the core form of the forthcoming thresholds/disclosure regime established before being asked to give views on valuation methodologies. We therefore request that the Commission reconsider its timetable and the sequencing of its Part 4A tasks in order to ensure that these are undertaken in a coordinated manner, in part to ensure that their sequencing provides the policy context necessary to respond.

Rearranging priorities in this way would not be a breach of the Act’s “as soon as practicable” requirement, as it is not practicable to consider the detail of asset methodology issues until the broader context of the regime they are to be applied in has been defined.

Purpose of the Valuation Methodology

The societal costs of making major changes to the industry’s regulatory environment at a critical time should be given appropriate attention in considering the case for changing the valuation methodology and/or the use to which valuations are put. In particular a shift from optimised deprival value to historic cost for regulatory purposes is likely to result in a number of serious adverse outcomes. Underlying our concern is an awareness in the industry that ongoing and significant investment in new transmission and distribution facilities is required to support economic growth and to meet increasing demanding consumer requirements for quality and security.

The new thresholds regime could enhance the ability of consumers and line companies to identify and meet fundamental electricity supply challenges if it has a focus on the industry’s performance in delivering services. Price and service quality are central to this. There is probably scope to extend the list of outputs that the thresholds should encompass into areas such as power quality and long term supply security, but there is no obvious need to also magnify the focus that the disclosure processes apply to inputs such as valuation.

It is acknowledged that the Act’s ‘Subpart 3’ purposes of *information disclosure* are to include providing public information on profits, costs and asset values, as well as key outputs. The existing information disclosure regime with its low-key use of Optimised Deprival Value data seems adequate for public monitoring of performance in these areas. To date it has delivered good evidence that delivered energy charges, and particularly line charges, are exceptionally low, reflecting the consumer benefits that have resulted from efficiency gains. Reasonable public analysis of the data is available from a number of sources, although arguably there has been a gap in public information about the industry’s outstanding achievements in holding prices down and improving the quality of line service delivery.

Trends in Prices

Ministry of Economic Development International Delivered Electricity Price Figures: Change from 1996 to 2001 ¹						
	Residential Prices (Nominal, excluding taxes)			Industrial Prices (Nominal, excluding taxes)		
	Q1 1996	Q4 2001	Change	Q1 1996	Q4 2001	Change
Japan	34.83	50.89	46.1%	24.16	34.01	40.8%
Switzerland	23.17	26.40	13.9%	18.67	16.88	-9.6%
Portugal	24.21	28.06	15.9%	16.87	15.69	-7.0%
Austria	22.75	39.88	75.3%	12.82	18.64	45.4%
Italy	20.03	35.03	74.9%	12.62	20.43	61.9%
Spain	25.03	34.08	36.2%	12.29	13.27	8.0%
Germany	21.52	28.77	33.7%	11.72	13.55	15.6%
Luxembourg	18.66	28.30	51.7%	11.66	n.a	n.a
Turkey	10.19	20.21	98.3%	10.47	19.26	84.0%
UK	15.32	24.02	56.8%	10.33	10.94	5.9%
Netherlands	16.27	38.29	135.3%	10.21	13.79	35.1%
Ireland	17.67	24.42	38.2%	9.75	11.79	20.9%
Belgium	23.75	39.86	67.8%	9.74	13.10	34.5%
Denmark	13.87	47.56	242.9%	9.53	14.27	49.7%
Finland	12.90	18.79	45.7%	9.09	9.27	2.0%
Greece	14.55	21.33	46.6%	8.93	11.68	30.8%
France	19.26	30.65	59.1%	8.86	11.11	25.4%
Australia	11.76	19.05	62.0%	6.97	13.41	92.4%
Hungary	7.34	16.65	126.8%	6.72	12.37	84.1%
Sweden	10.54	24.07	128.4%	6.60	8.13	23.2%
USA	11.75	19.74	68.0%	6.23	9.75	56.5%
Canada	8.85	14.17	60.1%	5.69	9.11	60.1%
Norway	8.20	17.12	108.8%	4.40	8.09	83.9%
Mexico	6.16	18.55	201.1%	4.20	11.18	166.2%
New Zealand	10.97	13.55	23.5%	6.39	6.90	8.0%

The following gains in relation to other regimes are evident from these figures (regardless of any exchange rate or purchasing power impacts):

- New Zealand's delivered domestic and industrial electricity prices have become the lowest in the OECD under the current regulatory regime.
- Australia's domestic electricity price has risen from 107% of New Zealand's to 140%.

¹ MED Energy Data File, July 1997 (page 126) & July 2002 (page 140).

- Australia's industrial electricity price has risen from 109% of New Zealand's to 194%.
- Nearly all OECD member countries have seen far larger domestic price rises than New Zealand has, despite the pressure to remove cross-subsidies to domestic users that have appeared here since 1992. This reflects a global trend towards market-driven rather than politically imposed domestic pricing. (The only exceptions, Switzerland and Portugal, began with – and still have - much higher prices.)
- New Zealand domestic and industrial consumers both now enjoy electricity prices that are 50% of the OECD average.

We accept that these figures are not focused just on changes in transmission and distribution charges but cover the overall delivered electricity price. Also, we believe that – within this delivered price - New Zealand's average energy charge (i.e. electricity disaggregated from lines) is one of the lowest in the OECD, suggesting that – despite the absence of a regulatory focus on the energy component of prices, and the relatively limited level of competition in the New Zealand energy market – the existing system is delivering exceptionally low energy prices to consumers. However, the MED has also published² a breakdown of New Zealand domestic delivered electricity prices from April 1998 to August 2002 that shows that, in the period since line/energy separation, weighted average line charges falling by \$8, while weighted average retail (delivered energy) charges rose by between \$24 (cheapest retailer) and \$112 (incumbent retailers). This demonstrates that New Zealand's electricity distributors have out-performed even the strongly performing retailers in delivering cheap electricity to households under the current light handed regulatory regime.

We believe that the balance of evidence (especially the trend towards the removal of distribution cross subsidies to domestic users in New Zealand) indicates that non-domestic consumers, too, have benefited from very low line charges.

Trends in Service Levels

The existing information disclosure system has not produced any evidence of a decline in service standards, which appear very satisfactory when compared with overseas systems.

We recognise that there is a mixed public perception of service levels in the electricity industry associated with the disruption caused by generation and line/energy break-up after the Electricity Industry Reform Act 1998. However,

² See information on MED web site at http://www.med.govt.nz/ers/inf_disc/prices/prices-16.html

most line companies enjoy good relationships with consumers, as suggested by the very few complaints about line company service received by the Electricity Complaints Commissioner (the Commissioner reported to the ENA AGM in October that around 90% of the complaints handled related to retail rather than line issues).³

Physical service measures present a favourable picture. Power quality levels in the lines industry, as measured by SAIFI, SAIDI and CAIDI, have shown significant gains under the prevailing regime, with New Zealand line companies also out-performing their Australian counterparts, and making strong relative improvements in service quality over the past 4 years:⁴

	SAIFI				SAIDI				CAIDI			
	97/98	98/99	99/00	00/01	97/98	98/99	99/00	00/01	97/98	98/99	99/00	00/01
New Zealand	2.61	2.95	2.09	2.02	179.0	211.5	130.1	134.4	68.6	70.7	62.2	66.5
Australian Average	2.51	2.5	2.86	2.22	179.88	181.77	189.04	182.15	67.20	72.60	66.10	82.05
NSW & ACT	2.16	2.23	2.07	2.30	152.37	146.63	114.68	150.03	72.50	65.66	55.35	65.23
Victoria	4.13	3.55	3.49	1.96	194.77	172.93	174.22	163.97	58.18	48.68	49.97	83.66
Queensland	2.25	2.50	2.79	2.71	275.00	301.49	281.74	279.13	90.00	120.60	94.00	103.00
South Aust	1.38	1.21	3.84	1.76	112.62	116.90	193.40	167.73	96.30	91.20	63.60	95.36
Western Aust	1.50	1.60	3.16	1.48	149.00	127.00	231.00	134.68	92.00	79.38	73.00	91.00
Tasmania	1.73	2.29	2.7	3.14	132.60	237.16	277.00	292.02	73.54	105.16	108.00	93.00
Northern Territory	7.83	6.47	4.23	6.00	395.00	352.15	219.94	233.40	46.50	54.40	41.87	38.90

International Comparison for 2001-02 ⁵

	SAIDI	SAIFI	CAIDI
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³ Note: pricing issues are excluded from the ECC scheme, and most complaints handled involve service and other quality issues.

⁴ Brian McGlinchy, 'Reliability of Electricity Distribution Networks Year ended March 2002', September 2002 (page 78 for Australian figures, page 17 for NZ figures). NZ 1997/98 data from same publication April 2000 edition (page 17).

⁵ Brian McGlinchy, 'Reliability of Electricity Distribution Networks Year ended March 2002', September 2002 (page 78).

	SAIDI	SAIFI	CAIDI
New Zealand			
Australia			
Canada			
United Kingdom			

The above table indicates that only the UK had a better record than NZ in terms of minutes per year when the average customer is without supply (SAIDI) and number of interruptions per customer (SAIFI). The UK's superior performance appears to result from the multiple supply routes available in its high customer density system. Nevertheless, NZ out-performed even the UK in terms of limiting the average duration of an interruption (CAIDI).

Also, line companies have made and continue to make a constructive and growing contribution to a range of consumer-focused quality enhancement processes, such as the establishment of the Complaints Commissioner scheme, the development of the EGB, MARIA, and Grid security arrangements, etc. This progressive contribution can be linked to the way valuation issues are handled under the existing regime: while ODV does not capture the value of contracts and relationships, its use simply as a common denominator for light handed performance comparisons prevents the commitment of resources to work of this type being regarded as a cost that should be avoided unless it is specifically recognised in valuation rules.

Members' responses will provide commentaries on the lack of robustness in historic cost information available to the lines industry. Vesting valuations were assembled in 1992-93 with little accounting rigor, and to a tight deadline designed to achieve rapid Corporatisation rather than to address valuation principles. ODV was then imposed, from 1994, for clear policy objectives which in part recognized the shambolic situation that existed at vesting. We see no value at all in returning to that situation.

Impacts of a Shift From ODV on Line Charges

In our view the current approach to valuation, via ODV disclosure, reinforces the supportive and output focused approach that the lines industry has taken up until now. Adopting historic cost in place of ODV in tandem with the development of a price control thresholds regime implies a refocusing on company valuations as primary threshold elements. Such a shift from the light-handed regulatory use of valuation, where ODV has been developed to provide standardised comparative data, does not appear justified on the basis of line charges or trends in charges, as the information set out above demonstrates. In the longer term we envisage that it would contribute to a 'cherry picking' dynamic among retailers, involving arguments about the historic cost of specific assets serving certain end users, and pressures to offer specific asset-linked deals that would create unproductive tensions.

Impacts on Service Levels

Adoption of a new, valuation-focused regulatory regime in place of the light handed comparative process that ODV was developed for could also have negative impacts on service levels. First, we question the usefulness of such a change, and second we have concerns about the unforeseen impacts it could have on an industry that has a strong focus on maintaining a level of power quality that is in step with evolving consumer requirements.

There is an increasing blurring between what would potentially be ‘regulated’ and ‘unregulated’ assets associated with power quality. Scope exists to integrate investment in activities such as metering with advanced voltage control, power quality monitoring, remote connect/disconnect facilities, and so forth. However, if regulatory rigidities are created around asset investment then emerging technologies of this type will be discouraged.

Impacts on New Investment

The most probable result of a regulatory focus on changing the way potential investors value existing assets would be a widespread decline in investor confidence in all aspects of the lines industry, including new investment. As long as the forthcoming thresholds regime is focused on price movements and quality levels there is no reasonable case for creating a consequential link between the regulator’s perception of value and allowable prices.

Our perception is that the distribution industry will need large inputs of capital over the next decade to keep pace with economic growth and the pressures to deliver computer-age power quality. So far, investors in locally owned line companies have provided the capital necessary to produce the improvements in service quality and security noted earlier. However, a shift to a more aggressive regulatory use of valuation would mean a profound shift in investor perceptions, with the regulated value of a company being highlighted as a primary determinant of future income. There is already a trend for overseas investors to abandon the New Zealand electricity industry, suggesting that it is not delivering attractive returns even now. We have also noted a trend for insurers to make cover for distribution (and transmission) risks increasingly difficult to obtain, highlighting the increasing awareness of the exposure to such risks that investors in distribution assets face.

An important area where major new investment will be required is in providing supporting infrastructure for distributed generation, where distributors are having to shift their focus from investing in *energy delivery* to investing in a more active *energy balancing* service. New investment risks are associated with commercially vulnerable local power plants, and mechanisms for pricing distribution services in ways that are fair and in line with Government policy are evolving. While there is no firm data on the extent to which future electricity needs will be met by distributed generators, a range of drivers (the decline of Maui gas, environmental issues, Government policy, competitive forces, and the

legislative changes made last year to allow distributors to invest in sustainable local generation) all suggest that a large number of significant investment decisions will need to be made, and that a stable investment climate should be considered a priority if distributed generation is to help fill the looming energy gap. Imposition of another fundamental regulatory change on the industry would mean that this stable investment climate would not be in place when critical energy supply decisions need to be made.

Impacts on Rising Input Costs

A line company's controllable costs are a relatively small component of its overall costs. The period after the Energy Companies Act 1992 saw dramatic labour shedding take place: employment in 'electricity, gas and water' dropped from 13,500 in February 1992⁶ to 7,100 in November 1998⁷. The scope for further efficiency gains in this area appears more limited now. Currently there are upward pressures on wages, on risk management (including insurance), and on prices of materials – where import costs are a key factor. In addition, the industry is facing a series of new 'add-ons' ranging from the Commission's levy to local body rates, and also including contributions to the Electricity Complaints Commissioner service, and potential new costs from the EGB. There is also the prospect of very large new costs associated with Resource Management Act compliance and associated legal processes during the next major phase of new capital investment.

We do not see any justification in the data available to us to suggest that imposing further input costs through a shift to a new valuation methodology, and/or through a more prominent role for valuation in the overall regulatory regime, is justifiable. In fact, given the pending shift to what should be an output-focused price control thresholds regime, we question the need to monitor valuations in any detail after 2002.

Few Parallels With Other Infrastructure Valuation Issues

Line companies are conscious of the emerging need for extensive investment in distribution assets to sustain economic growth and to meet increasingly stringent consumer demands for delivered electricity quality. They are also conscious of the electricity industry's complexity and interdependence, and of the importance of preserving and enhancing relationships that ensure investment and pricing signals from all parts of the supply, transmission and distribution chain reach stakeholders. Here there are few parallels with other infrastructure providers, such as airfield companies.

The following points are relevant:

⁶ Department of Statistics 'Key Statistics' October 1992, page 39

⁷ Department of Statistics 'Key Statistics' September 1999, page 34

- We believe that the regulatory regime that will apply to the lines industry (assuming that the *thresholds* element has a focus on outputs) will provide an adequate safeguard against unreasonable pricing or declining performance if it is accepted that – as the evidence suggests – line charges and service quality levels are satisfactory at the commencement of the new regime.
- Land value is a relatively small issue in line company valuations, where the key assets are clearly depreciable.
- Historic cost is not appropriate for line companies, partly because of the inadequate and uneven historical data involved, and partly because – if valuation is considered relevant to the future regime – there is a well-established process in the ODV rules for ensuring that optimisation of DRC takes place.
- Arguably, there may be a theoretical case for infrastructure providers to have a major regulatory shake-up in order to establish a rational base for operations that have evolved through haphazard processes. If this is so, then the electricity lines industry has already had its share of such shake-ups.

Conclusion

- There seems to us to be very strong evidence that the electricity lines industry has performed well up to now in delivering improved efficiency and service quality, and in sharing the benefits of efficiency gains with consumers. There is no evidence that we are aware of that companies in the industry are extracting excessive profits. Accordingly, we see no justification for the Commission imposing new costs and uncertainties on the industry by making major changes in the way valuation is disclosed for regulatory purposes.
- Anyway, we believe that the Commission will not be in a position to make well-considered decisions on a new valuation methodology until it has decided on the structure of its new price control thresholds regime, and the role that valuation information should play in that regime. We therefore recommend that the review of asset valuation methodologies be frozen at this point, to allow it to be considered after work on the thresholds design has proceeded.
- The lines industry has reduced charges and improved service quality in an environment where most input costs are external and driven by changes in labour costs, by new imposts such as local body rates on poles and lines, by changes in materials costs (copper, aluminium, transformers and switchgear etc) and by increasingly complex land access and Resource Management Act processes. It is facing major challenges as the demand for new power supply rises, and as local generation becomes more significant. Imposing new valuation rules and/or using asset valuation as

a mechanism for forcing prices down further would be unreasonable and potentially destructive.