SUBMISSION TO:

The Commerce Commission
on

Discussion Paper:
Review of
Asset Valuation Methodologies

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From Trust Owned Line Companies:

- Network Tasman
- Westpower

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Introduction

This submission represents the views of Westpower and Network Tasman Limited. We appreciate the opportunity provided by the Commission to comment on valuation methodologies prior to the final declaration of the regulatory regime. We commend the Commission on the quality of the discussion paper and on its move to align and integrate the threshold and valuation work streams. We would also like to see the information disclosure work stream integrated into this process as quickly as possible.

Summary of Key Points in our Submission

1. Integrated Approach

Where possible we would like to see the regulatory valuation methodology and information disclosure requirements integrated with financial reporting requirements under GAAP. This will avoid running multiple 'sets of books' and will minimise compliance costs and improve transparency.

2. Opening Asset Values

We submit that ODRC is the preferred methodology for establishing opening valuations for line business. We promote this view on the basis that:

- EV tests are generally not cost beneficial
- The ODRC methodology is robust and well grounded in economics.
- ODRC is more likely to promote economic efficiency over the longer term than other valuation methodologies eg HC.
- ODV/ODRC has been explicitly and implicitly legistimised by the state over the last decade.
- ODRC is by and large consistent with Australian regulatory practices.
- Line businesses have established and invested in robust and sophisticated systems and process to support the ongoing use of ODRC/ODV.
- Independent experts have recently verified existing ODVs and ODRCs. Very few material errors were identified in this process. The valuations are robust and comparable.
- ODRC is consistent with financial reporting practices required under FRS-3 and the valuation approach adopted by local authorities for rating purposes.
- ODRC is more likely to support rural and remote reticulation beyond 2013.
- Continuity of use of ODV/ODRC will retain investor confidence in the sector and minimize capital costs by lowering the capital markets perception of regulatory risk.
- Continuity of use of ODV/ODRC will enable the existing information disclosure data base to remain useful and relevant
- Use of ODV/ODRC will facilitate a shorter timetable for implementation of the final regulatory thresholds and control regime.
- Use of ODV over the last decade has left NZ line company performance benchmarking favorably against international peers in terms of price and quality (see ENA submission of data).
- Use of the ODV methodology over the last decade has lead to stable nominal and falling real line prices

- This trend should continue into the future if ODV/ODRC is retained, however increases in rates, insurance, compliance, regulatory and industry governance costs raise doubts whether this will be the case.

3. Handbook Revision

While supporting the use of ODRC we also submit that the existing ODV Handbook requires revision and enhancement. In particular:

- Standard replacement costs require review; they are now eight years old.
- New asset classes should be introduced (eg, 22kV lines, cables & transformers and LV boxes).
- Treatment of fully depreciated assets that retain service potential requires re-consideration.
- Asset lives could also be reviewed.

Generally we concur with Parsons Brinckerhoff recommendations to the Commission concerning the handbook items for review and enhancement.

4. Use of HC & DIHC

In our view DHC and DIHC are not appropriate for setting the opening system fixed asset valuations. The necessary records generally do not exist, cannot be readily recreated and any data available will be of very dubious quality and reliability.

Use of vesting values established in 1993 is also inappropriate because:

- Vesting values were generally not derived from a comprehensive and reliable set of historical records.
- Vesting values represented an amalgam of business activities and not just those of the monopoly lines component (ie, also included appliance retailing, contracting, advisory services and energy retailing).
- In some instances (eg, NTL) the vesting valuations were earnings based (DFC) and reflected the revenue, costs and net earnings structures derived across the range of businesses operating at the time.

5. Ongoing Asset Values

We submit that for ongoing regulatory asset values ODRC should be used. This would promote consistency with our view on opening values. However our recommendation is qualified by the necessity for update of standard replacement costs in the current handbook.

In many instances actual capital costs now exceed standard replacement costs and firms face upfront valuation write-downs. In absence of a review and update of replacement costs we would prefer DHC or DIHC going forward. DHC would provide firms with more certainty that their actual capital expenditure will be fully captured in the regulatory asset base. Continued dislocation of standard replacement costs and actual capital costs will lead to under investment and demands for higher capital contributions from customers to fund shortfalls.

6. Evaluation Criteria

In terms of the **Economic Efficiency Criteria** we submit that:

a. **Allocative efficiency** has the lowest order of priority in valuation selection due to:
   - The inelastic nature of demand for electricity and line services in particular.
   - The requirement for use of "second best" line pricing structures given average costs on electricity networks normally exceed marginal costs.
   - The extent to which political and social interference is now overriding efficient economic pricing (eg, low fixed charge tariffs and requirement for low differentiation between urban & rural tariffs).
   - The demands by retailers for pricing simplicity to override the complexity and volume risk transfer associated with economically efficient line tariff development.

b. **Productive efficiency** is of second order priority with respect to the valuation process. However it is important that today's consumers gain assurance (from the industry and its regulator) that line services are being delivered at the lowest sustainable economic cost. Our view is that ODV/ODRC valuation methodology best supports this requirement.

c. **Dynamic efficiency** must have first order priority with respect to the valuation process. The industry has very high levels of capital intensity centered on assets with very long lives and high levels of specificity in their use. A valuation process that encourages the right type and quantity of investment at the right time and in the right place is preferred.

   Large capital investment in both the transmission and distribution sectors will be necessary to service the projected demands from load growth over the next decade. Capacity in existing systems is progressively becoming scarce. If this investment is to occur the regulatory valuation methodology chosen should not create new hurdles and constraints that compound the existing difficulties (access, RMA and local authority restrictions) line businesses face when trying to get new capital projects off the ground. The methodology should ensure new capital expenditure is adequately rewarded and it should not create perverse incentives that will lead to inefficient investment.

   Again we believe that ODV/ODRC provides the best incentives for sensible long-term asset investment and management.

In terms of the **Cost Effectiveness Criteria** we submit that
   - Minimising administration and compliance costs is important. In particular additional regulatory costs imposed on firms that are not in breach of the thresholds will simply create an unproductive burden on consumers.
   - The use of ODRC/ODV for opening values is desirable as it will leverage off the existing sunk costs associated with established valuation systems and processes. Also independent verification of ODRC/ODV has already been completed.
   - The costs of using HC or ODRC going forward are unlikely to be materially different given the Commission will inevitably get drawn into detailed and extensive capital efficiency reviews should HC be adopted.

7. Investment Risk

In terms of management of investment risk through the valuation process we would make the following observations:

a. Investment risk in general is best left with the asset owner where it will create the most appropriate drivers in terms of planning, evaluation and management of capital and maintenance expenditure.

b. In general we regard adjustments to WACC as a rather blunt instrument that will not deal directly or adequately with what are likely to be isolated problems with specific assets.

c. Adjustments to deprecation rates applicable to specific stranded or obsolete assets provide a more appropriate and targeted way forward. However this approach will engender a process that is more bureaucratic.

d. Our view is that technologic risks on primary plant are limited for the foreseeable future (next 3-5 years) however what is likely to happen beyond that point is highly debatable. Technological risks in some other areas such as electronic management systems are already high.

e. Stranding risks tend to be associated with exposure to particular large customers and industries. Large customer risks can, in part, be handled through bilateral contracting. Industry exposure eg, timber and dairy industry failure, is a more difficult problem to handle. This again could again be accommodated through economic depreciation concepts where adverse exposures are realized. In general where regions have a broad base of ongoing economic growth, stranding risks are moderated significantly. No or low growth areas have greater exposure.

f. Investment risks for line businesses under the existing ODV methodology have a tendency to be asymmetrical on the downside. This has been one of the factors claimed by Transpower to have hindered new investment on the grid.

g. Inflation creates risk for line businesses and potential rate shocks for customers if not recognized in some manor through the asset valuation methodology. ODRC handles the inflationary impact appropriately but revaluation gains and losses could be 'smoothed' over time. TPNZ economic value accounting methodology provides a pretty good model for this. We prefer replacement costs methodologies to general indexation approaches as it is more industry and asset specific and therefore should produce a fairer result for both consumers and businesses.

Responses to specific questions posed by the Commission

Chapter 2 – Purpose of the Review

1. Should the same valuation methodology necessarily be used for thresholds assessments and for control?

The same valuation methodologies should be used. It is inconceivable why they might be different.

2. What factors should be considered in deciding whether a consistent or different approach is desirable?

Consistency is paramount so type I and II errors are avoided ie, the thresholds fail to detect poor performers or good performers are in breach of the thresholds.

3. What level of detail regarding asset values should be publicly disclosed? How should asset valuation requirements be prescribed in practice (eg, a handbook)?

Current ODV break down and use of handbook and information disclosure requirements seem appropriate for systems assets.

4. To what extent should there be any different approach to asset valuations (than for thresholds and control) used for disclosure purposes?

Ideally, the approaches should be the same especially as disclosure information will be used in threshold assessments. Alignment with Financial Reporting standards is desirable so compliance costs are minimised.

Chapter 3 – Evaluation Criteria

5. Are the proposed evaluation criteria of efficiency, excessive profits and cost effectiveness for assessing the valuation methodologies appropriate given the regulatory context in which asset valuations may be used?

Criteria seem acceptable but some overarching principles such as consistency, transparency and comparability should also be put in place.

6. What other evaluation criteria, if any, should the Commission consider?

See five, above.

7. In assessing asset valuation methodologies for system fixed assets, how important is allocative efficiency?

It is of some importance but will come into conflict with Government policy with respect to low fixed charge tariffs and minimization of rural/urban tariff differentials. Retailers also place significant constraints over efficient and cost reflective tariff design. Allocative efficiency is of a lower order of importance compared to dynamic efficiency.

8. How are the level, structure and profile of prices over time affected by the choice of valuation methodology?

Asset valuation methodology has a significant impact on the general level of tariffs. However the structure of prices is more influenced by other factors (see Question 7). The profile of prices has some modest relationship to the asset valuation methodology used.

9. How does the choice of valuation methodology affect service quality and the ability for electricity lines businesses to provide services of a quality that reflects consumer demands?

Is of significance, as firms will only invest in capital that delivers quality enhancements if a fair return on investment can be gained. This in turn depends on standard value allowances, depreciation rates and optimisation criteria applied within the chosen valuation methodology.

10. In assessing asset valuation methodologies for system fixed assets, how important is productive efficiency? What factors should be considered?

Productive efficiency is reasonably important, especially for today's customers and for delivery on short-term government policy and regulatory goals. However valuation methodology should not be biased towards today's consumers at the detriment of tomorrow's consumers (ie, dynamic efficiency should have priority).

11. In assessing asset valuation methodologies for system fixed assets, how important is dynamic efficiency? What factors should be considered?

Is critical because of the high long-term asset intensity in the industry. Good long-term investment decisions will produce the best service, at the right time, in the right place and at the lowest possible sustainable cost for consumers. Asset specificity is also very high so poor investment incentives and decision making will be very costly to future consumers and/or investors.

12. How important is the identification of excess returns as a criterion for the assessment of valuation methodologies? What factors should be considered?

Is unavoidable given current Part 4 Purpose Statement guiding the Commissions work. This raises some key issues about maintaining the attractiveness of the industry to capital markets in the long term and the development and maintenance of a consistent and

reasonable regulatory approach to line business profitability so adequate returns will be made on new investment.

13. How important is cost effectiveness as a criterion for the choice of valuation methodology? What factors should be considered?

Absolutely critical, it is inefficient to burden consumers with extensive new regulatory costs where firms are already behaving in a reasonable and constrained manner. The valuation regime must pass a fundamental benefit/cost test otherwise it will be a burden rather than an enhancement for consumers.

Chapter 4 – Valuation and Regulatory Control

14. How great is the scope for bilateral or multilateral contracting regarding asset investment?

Reasonably modest. Probably only practical for top 1%-2% of consumers and is impractical for mass-market customers serviced through UOS agreements with retailers. We note however capital contributions for new loads is a type of bilateral contracting which is common in most networks.

15. How should contractual management of asset-related risks be dealt with in the context of regulatory asset valuation?

Should be treated separately from the general pool of assets. Generally there is some bypass tension whenever bilateral contracts are a viable alternative.

16. Who is best placed to manage the various forms of investment risk faced by electricity lines businesses?

Generally the asset owners are best placed to manage risk as they have both the knowledge of the assets and the accountability for their efficient use. However there is a potential under regulation, especially with use of ODV, for line business investment risk to be asymmetrical, on the down side.

17. In a regulated environment, how should investment risks be compensated? Is it preferable that some risks be compensated through WACC and others through the valuation methodology (eg, through the choice of depreciation regime or treating revaluation gains/losses as income)?

Can be a combination of either but will depend on asset valuation methodology chosen. WACC compensation appears attractive but is a fairly blunt instrument. Current ODV optimisation and EV tests are appropriate however unrealistic standard replacement costs are creating asymmetrical investment risk. Use of specific depreciation allowances for assets identified and agreed to be at risk would seem desirable.

18. What are the relative merits of dealing with inflation through WACC or the valuation methodology?

It is preferable, simplest, and most transparent to use nominal WACC, with inflationary asset revaluations being brought in as income. The component of any asset revaluation driven by inflationary replacement price movements should be separately identified.

19. Is it appropriate that investors bear the risk of asset failure? In what circumstances would it not be appropriate for investors to bear the risk of asset failure?

Depends what is meant by failure. Where assets physically fail it is only appropriate for consumers to bear this cost if the failure is uninsurable or liability could not be pushed back on the original supplier/contractor. It is also an issue of ELB's taking due care in their installation and maintenance programs. If good industry practice has been adhered to then some recovery would be reasonable unless the loss was insurable.

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

Adherence to Financial Reporting Standards requires depreciation to be assessed annually and account be taken of the remaining service potential left in the asset. There should therefore be limited divergence between the two.

21. How should assets be treated when they remain useful beyond their expected life?

Some allowance is required otherwise inefficient replacement capital expenditure is incentivised. The Parsons Brinckerhoff recommendation would seem a reasonable way forward.

22. How should uncertainty as to the useful economic life of an asset be accounted for in terms of regulated depreciation?

Where the issue becomes material, individual cases could be put before the commission for consideration. We do not see this as a major issue over the next 5 years. However as many asset lives exceed 40 years it may become significant in the longer term.

23. What effect would economic depreciation have on price profiles over time?

NTL is of the view that in the current environment the impact of economic depreciation on pricing would be relatively modest.

24. Is capital efficiency best determined ex ante or ex post, or by a mixture of both? Are some factors pertaining to capital efficiency best considered ex post and others best considered ex ante? How are capital efficiency assessments best conducted?

NTL's view is that a mixture of both ex-ante and ex-post assessment would be best. Ex-ante assessments of AMP's is important as it will reduce the risk of opportunistic behavior by the regulator. NTL suggests annual or biannual review and sign off of AMP's and ex-post optimisation and prudency tests every three years. Clear optimisation and prudency test rules and approval criteria for AMP's must be established on an ex ante basis by the regulator.

25. What investment incentives do the various types of capital efficiency reviews create?

Optimisations/prudency tests discourage over investment, create asymmetric investment risk and may create incentives to under invest. They will also encourage bilateral contracting (eg, TPNZ New Investment Agreements) and potentially drive up the level of customer capital contributions sort by line companies. Ex-ante capital expenditure review will diffuse line business accountability, facilitate opportunistic behavior by the regulator, draw the regulator into management issues and create regulatory responsibility for asset development and security.

26. How frequently should capital efficiency reviews be conducted? What factors should be considered in deciding how frequently to conduct such reviews?

See Question 24 – AMP's reviewed and approved annually/biannually and optimization/prudency tests every third year or longer. The Commission must trade off the cost and intrusiveness of more frequent reviews against potential lose of control over unacceptable practices.

27. Does the level of inflation/deflation in the electricity industry suggest one valuation methodology would be better than others? Would compensation for inflation through indexation preserve the purchasing power of investors' committed funds? What are the pros and cons of indexation?

Key current issue with inflation is that standard replacement costs under the ODV methodology have not been reviewed for eight years and frequently do not cover full 'in situ' costs of new capex. An HC or IHC approach for new capex is desirable if the RC's are not updated. However our preference is to correct the current deficiencies in the ODV Handbook and some indexation or more frequent review of standard RC's would help to preserve investor purchasing power.

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

Given the Commissions goal to minimise compliance costs and maintain transparency, the Commission should as far as possible align the asset valuation methodology, information disclosures etc with conventional accounting standards and FRS-3 in particular.

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

Accounting treatment for capital contributions which is dealt with elsewhere, the splitting of expenditure between asset renewals (capex) and maintenance and depreciation requirements under accounting standards.

30. What scope is there for substitution of capital and operating expenses for electricity lines businesses system fixed assets?

Some scope; especially when assets are older or have been fully depreciated yet still retain useful service potential. The capex cycle can be shortened for some assets by working them harder and/or limiting maintenance expenditure. The converse is also true.

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

Preferable not as this may conflict with formal accounting requirements and create additional compliance costs. However for the thresholds and benchmarking to work properly disclosures will have to be consistent and comparable. It is inevitable the Commission will get drawn into prescribing accounting policies for information disclosures over time, and these should be made consistent with GAAP wherever possible.

Chapter 5 – Asset Valuation Methodologies

32. Are there some system fixed assets that could be put to alternative uses outside of the electricity industry and, therefore, appropriately valued at opportunity cost? What assets have high specificity (ie, only have value in their current use)?

Some components such as transformers are reasonably mobile and there is a limited resale market for them. However the bulk of systems fixed assets other than land and transformers are highly specific and they incur very low opportunity costs.

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?

Basically these transaction could have been driven by expected synergies, potential to build non regulated income flows, strategic opportunities, growth opportunities, optimistic views on future regulatory constraints, the level of non-system assets, views on the value of intangibles and acceptance of a WACC below expected norms.

34. What are the pros and cons of combining capital efficiency reviews with a historic cost approach? How great is the scope for capital efficiency reviews under a historic cost method?

There are two key issues – firstly was the capital expenditure physically required and secondly was it economically performed (least cost). The first question is largely non financial and can be dealt with under prudency/optimisation tests. The second question requires EV testing and some view on 'standard/reasonable' costs. The later is problematic without some notion of reasonable and standard levels of expenditure on particular capital items. There is a real risk of the Commission being drawn into significant and detailed reviews of the annual capital spends of all line businesses.

35. What events could be used as a base for valuing system fixed assets at historic cost? What are the relative merits of using the book values at each of these particular events as a base for a historic cost value? What would be the most appropriate date to use for assessing the historic costs of electricity lines businesses?

To our knowledge there are no reasonable events or records for establishing a Historic Cost valuation of the network. The only possible notional assessment technique would be via a review and replacement of the standard replacement costs currently used in the ODV methodology. However this will only produce some proxy that is likely to be reasonably similar to ODV.

36. What are the pros and cons of indexing historic cost values for inflation?

The key benefit of indexing is the retention of investor purchasing power that creates an incentive to replace existing assets while avoiding rate shocks to consumers. However indexing is a blunt instrument in that it assumes ELB capital works costs will change at the same rate as the general level of prices. This is unlikely to be the case.

37. How important is it that an asset valuation methodology replicates or mimics competitive market outcomes, given the regulatory objections of Part 4A and the Commission's evaluation criteria?

Given the evaluation criteria established and Part 4A Purpose Statement requirements there is little choice but to seek an asset valuation methodology that replicates/mimics competitive market outcomes. It is questionable however whether the standard should be that of a reasonably contestable market or that of the mythical perfectly competitive market. The outcomes expected for each type of benchmark are considerably different.

38. Does the ODRC approach have economic merit in terms of mimicking competition? Do any other asset valuation approaches have more merit in this regard?

Competitive markets operate around DCF valuations where no party has influence over output prices. ODRC was developed to overcome the problem of valuation models reflecting captive pricing opportunities available to monopolies. It therefore has serious merit over other lesser contenders and should not be set aside for expedient reasons.

39. If electricity lines businesses have revalued their assets in the past but have not matched those revaluations with income forgone, should their current return on capital be calculated using a real WACC?

It is not clear that revaluations have always been driven by changes in replacement costs. Revaluations should be split into the underlying components eg, new capex, previously unaccounted for asset, revision of asset ages, change in replacement costs etc.

40. If revaluation gains have not been treated as income, should consumers now be compensated in some way? If so, how?

This question can only be answered after detailed analysis of the revaluation drivers. Some ELB have 'found' unaccounted for assets as their systems developed and these may look like revaluations. The ELB's in this instance could argue for compensation for prior under recovery.

41. Are there likely to be significant differences between the inflation of asset prices and the inflation implicit in a nominal WACC calculation?

Difficult to answer authoritatively. Asset prices are probably more sensitive to exchange rates, commodity prices and contracting costs/contestability than general consumer prices. Asset prices are not subject to the same diversity of influences or intensity of competition.

42. If businesses bear the cost of downward revaluations is this risk asymmetric (ie, to the disadvantage of investors) and how could it be reflected in the WACC without compromising incentives for efficient investment?

Between optimisations, EV tests, non- review of RC's, asset ages etc there is a tendency for investment risk to be asymmetrical. TPNZ have held this view for sometime and it has become an impediment to new grid investment. Compensating via WACC is a pretty blunt instrument and we prefer more direct and transparent ways of dealing with the problem.

43. If businesses bear the cost of downward revaluations is this risk asymmetric (i.e. to the disadvantage of investors) and how could it be reflected in the WACC without compromising incentives for efficient investment?

Duplication, see Question 42.

44. How important is an EV assessment to the theoretical underpinning of ODV?

Theoretically useful but practically appears to be of limited value. NTL's view is the costs of performing EV tests outweigh the benefits and focus should shift to ODRC as required for financial reporting purposes under FRS-3 and as used by Australian regulators.

45. Why does the EV component have a limited impact on ODV values (as per the ODV Handbook)? Are the factors identified by the Commission significant?

The factors identified by the Commission are appropriate. By nature, the EV tests simply confirm that alternative forms of energy delivered to small consumers in remote areas is very expensive. We find it remarkable that this should come as a surprise.

46. What are the additional costs of an EV assessment (over and above an ODRC assessment)? Do the costs outweigh the benefits?

We are of the view that the costs do not outweigh the benefits and ODRC should be used rather than ODV.

47. Are there significant numbers of "uneconomic" customers for electricity lines businesses? How should the costs of any uneconomic customers be allocated?

There are 'uneconomic' customers; in particular they are low use customers and those in rural segments of the lines businesses. However this is in part due to unwillingness to adopt economic based fully cost reflective pricing. This has come about by a combination of government policy requirements (eg, low fixed charge tariff), retailers desire for simple and unsophisticated network pricing and unwillingness of network companies to strongly differentiate pricing geographically or to adopt strong two part pricing in the current environment. Inherent urban to rural and now large to small consumer cross subsidies generally involve a reasonably small levy across a large number of customers. Allocative efficiency concepts are weakened but not fatally damaged.

Chapter 6 – Current Use of the ODV Methodology

48. If the prescribed ODV method were to be used as an input into the regulatory functions under Part 4A, what, if any, changes would be required to the fourth edition of the ODV Handbook? What effect would any necessary changes have on the values of system fixed assets?

Implementation of the recommendations by Parsons Brinckerhoff would be useful. It is our view that ODRC is preferred to ODV (ie, drop the EV test) and in particular we regard that systematic and regular reviews of standard replacement costs, asset categories, asset ages and fully depreciated assets are warranted.

Chapter 7 – Industry Specific Issues

49. Are the standard costs currently listed in the ODV Handbook appropriate?

In some instances they are, in many they are not. Is it not unusual to find that standard ODV replacement costs are well short of actual capex costs. This is especially apparent where civil works and installation costs form a significant portion of the overall capital item.

50. How significant is the rate of technological progress and the potential for shifts in demand for the valuation of electricity lines businesses system fixed assets?

Our view that the rate of technological progress relating to primary systems assets is currently quite low, however it is considerably higher for electronic control and management systems and a number of non-systems assets. In a growth region the risks from a shift in demand are reasonably limited. Most risks are industry specific eg, dairy or timber industry and are often related to particular sites. The risk at these sites could perhaps be better managed through bilateral contracts.

51. Is there evidence that the replacement costs of system fixed assets will rise or fall (and how fast) relative to the rate of CPI inflation?

It is very difficult to make blanket statements. Component costs are reasonably stable but 'in situ' costs ie, including labour and works costs, are likely to increase at least at the rate of inflation given shortages of skilled labour and strong forward order levels faced by most contractors as a consequence of NZ's recent strong economic growth.

52. Is there evidence that rates of technological change are sufficiently high to warrant full depreciation over a period significantly shorter than the relevant asset's technical life?

Probably not at this juncture, especially for primary network plant, but this requires assessment from year to year as technology changes. There is more extensive technical risk associated with electronic network control and management systems.

53. What industry specific issues can affect the prudency of investment decisions? What relevance do these issues have for the choice of valuation methodology?

Industry specific issues include:

- easements and access rights
- RMA considerations
- local authority requirements and restrictions
- essential service attributes
- extremely long asset lives
- 'changing' land use that restricts/cuts off future development options
- social and political expectations
- uncertainty in growth forecasts
- economies of scale in component costs

All the above tend to induce over build as a means of avoiding intractable future problems, restrictions and costs. Valuation approaches that strongly optimize out overbuilt assets may increase future supply difficulties and costs. Often in this industry it is better to be "safe than sorry" and cheaper to move directly to a long-term solution than to approach it on an incremental basis over time.

54. Under what circumstances should capital contributions be excluded from the regulatory asset base? Where this is desirable, how should they be excluded?

Both the approaches identified in the document are used by Australia regulators. The key issue is to achieve a consistent, comparable and transparent approach to contributions across all line companies. Therefore we favour treating contributions as income and not excluding them from asset valuations. This is consistent with FRS-3.

55. Should assets associated with contestable services be ring-fenced from other system fixed assets? What evidence can be provided to demonstrate that specific agreements with one or more customers were negotiated on fair and reasonable terms and/or subject to competitive pressure?

Ideally they should be ring fenced. Communication with customers and review of documentation by the Commission would provide some assurance; however this is bureaucratic, invasive and may induce opportunistic behaviour.

56. Should the value of some assets be determined by the associated contractual revenue streams (rather than by reference to historic cost or replacement cost)?

It is probable that a revenue-based valuation will simply support ODV valuations for the assets employed and therefore will be of limited value.

57. What assets should be included as "system fixed assets"?

Systems fixed assets as described by the current ODV Handbook are reasonable but recognition of 22kV assets, LV boxes and pillars would be appropriate.

58. How should an asset be valued for regulatory purposes where it also provides line services that are not subject to regulatory oversight by the Commission?

Probably best done on an avoidable cost basis similar to what is used for "other businesses" in the information disclosures.

59. Should asset valuations be disclosed in respect of distinct network regions?

Potentially could be done by GXP especially for rural areas but greater asset subdivision may create complexity that provides limited value.

60. What is the best way to value land and easements? Should easements be valued differently to other system fixed assets? Are there any access concerns in respect of getting new easements or access to existing easements?

Registered valuations for land as a proxy for fair value and historic cost for easements. Easements are difficult and expensive to obtain on a retrospective basis. They are generally easier to obtain for network extensions where a customer is seeking connection.

61. What factors or considerations could provide a basis for different valuation approaches across different sectors?

Key drivers for different valuations are the different technologies and asset lives and specificities, and also the historical context eg, ODV has been historically sanctioned by the state for large electricity lines businesses.

Chapter 8 – International Practice

62. What lessons can be learned from international practice?

ODRC is used consistently in Australia and NZ should align itself with what is happening there. Regulation is expensive, intrusive and can produce significant detriments. NZ line business performance under light hand regulation stacks up very well against those countries that have practiced heavy-handed and intrusive regulation.

Chapter 9 –Implementation and Operational Issues

63. To what extent are the implementation and operational issues identified by the Commission relevant and, if so, to what extent for each valuation method? Are there any other implementation and operational issues that should be identified and, if so, how significant are they?

No comment other than the ODV processes and systems are now well embedded within the industry and its external support facilities. It would seem sensible to leverage off these (significant) sunk costs wherever possible. Any major changes will create resource and cost issues that will burden consumers.

64. If DHC (or DIHC) were the preferred method for establishing the baseline valuation of electricity line business system fixed assets for regulatory functions under Part 4A, how could this be best achieved?

There are virtually no reliable historical cost records prior to the mid 1990's; any HC valuation would have to be developed as a derivative of the existing ODV systems so why not simply use existing ODV's?

65. Up to what time were historic cost-based system fixed asset records maintained? Are possible difficulties surrounding establishing a true historic cost-based opening valuation genuine concerns? How could these difficulties be overcome, if at all?

Effective historic cost records are less than a decade old. It is our view they are completely unsatisfactory, to establish a 'true historic cost' opening valuation. A 'notional' HC assessment would be no better than ODV and would break the regulatory contract implicit in the existing state sanctioned light-handed regime.

66. If true historic cost could not be derived for the baseline valuation, is there a reasonable proxy for historic cost that could be used instead? What implementation issues might exist with a "reasonable proxy" approach?

As stated the only proxy would have to be one derived out of existing ODV systems.

67. What implementation or operational disadvantages or pitfalls might exist if the latest ODV value of system fixed assets were used for the baseline valuation, with future assets included and accounted for in the asset base at DHC (or DIHC)?

The existing ODV system requires enhancement – Parsons Brinckerhoff have pointed out a number of outstanding issues. Using DHC or DIHC going forward would be possible but would be inconsistent with ODV principles applying to the opening asset valuation and would not be consistent with FRS-3, which requires ODRC.

68. Assuming it was possible to determine a baseline valuation for system fixed assets using a historic cost-based approach (or a reasonable proxy for historic cost), what implementation issues might arise in attempting to align the detailed (ODV) asset records with the base line valuation? How could any implementation issues be satisfactorily addressed?

No comment – this is not an assumption we are prepared to make.

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 timeframe?

No comment other than that there is very little possibility of back working this approach accurately and cost effectively. The implementation and operational issues would not be insurmountable if it was restricted to a forward-looking approach only.

70. To what extent should the valuation method (DHC, DIHC, DRC, ODRC, or ODV) be prescribed by the regulator?

Would seem impossible for a threshold model and regulatory control to operate without a consistent, coherent and prescribed valuation methodology. Some prescription by the regulator seems inevitable.

71. If the ODV method were adopted for regulatory purposes, is the handbook for the prescribed ODV method adequate, or are changes required?

We suggest enhancements are required including consideration of removal of the EV test. The suggestion of Parsons Brinckerhoff require consideration and in particular the standard ages, standard replacement costs and treatment of fully depreciated assets will require specific review.

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?

In theory this ought to be possible but it will have a considerably lower level of rigor than existing ODV Handbook and inconsistencies and incomparable data is the likely outcome.

73. What implementation period would be necessary for implementation of the different valuation methods? What factors would influence the amount of implementation time needed?

Depending on the size and nature of the change it could take upwards of a year to fully integrate a changeover.

74. What factors are relevant to deciding the appropriate period between systems fixed asset (re)valuations for regulatory purposes? How often should (re)valuations of system fixed assets be undertaken for regulatory purposes?

This should be three to five years and preferably be aligned with requirements of FRS-3.

75. Should independent financial and engineering experts continue to be required to approve valuation reports?

These are required to add to the creditability of the valuation and this would seem important going into a phase of more active regulation – that is unless these roles are taken up by the Commission.

76. What are the advantages and disadvantages of using a common auditor across all electricity lines businesses? Should this process be undertaken by the Commission?

Presumably this is for asset valuation only, if not it is unacceptable.

77. What work do auditors currently perform under the electricity information disclosure regime in respect of system fixed assets? How does this audit work compare with audits carried out for statutory financial statement purposes? Are the audit scope and audit work carried out sufficient?

These auditors seek compliance with FRS-3 and to a significant extent rely on the work of the ODV experts and auditors when assessing ODRC.

78. What factors should be borne in mind when considering alternative valuation methods for Part 4A given that electricity lines businesses use system fixed asset valuations for other purposes?

Consistency with other uses where possible is important so compliance costs are minimised.

79. What are the costs associated with conducting a valuation under the different approaches? What costs would be incurred regardless of the methodology used? What costs are likely to be additional?

No comment due to constraints of time.

Chapter 10 – Comparison of Asset Valuation Methodologies

80. What are the pros and cons of limiting capital efficiency reviews to additions to the opening asset base? What level of cost savings could be achieved by limiting capital efficiency reviews to additions to the opening asset base?

This would be a positive initiative that would limit continuous ongoing review of the same issues. The cost savings ought to be significant.

81. What valuation methodology best promotes allocative efficiency? Please provide comment in terms of the level, structure and time profile of prices.

Probably ODV/ODRC but as already stated this is overridden to a significant extent by a number of external influences.

82. Could operational efficiency be improved by the choice of valuation methodology and, if so, how?

It is not immediately clear how valuation methodologies influence operational efficiency other than through the trade off/substitution between capital and maintenance expenditure.

83. How important is the ability to perform benchmarking to the choice of valuation methodology, particularly given the nature of system fixed assets?

Benchmarking is appears to be poised to have a key central role in the regulatory regime. If this is the case then asset valuation will be important to a number of the likely benchmarking measures.

84. What would be the financial and balance sheet implications for electricity lines businesses if profits or prices were constrained on the basis of a DHC (vesting value-based) valuation? What would be the implications of constraining prices on the basis of current ODV values?

Using vesting DHC values would be potentially very damaging. It would be disruptive to capital markets and probably see significant mark down in company values and an increase in required rates of return. Use of ODV would promote 'business as usual' and retain investor and capital market confidence and retain the investment attractiveness of the industry.

85. Are there any circumstances or considerations that would justify the regulatory valuation of assets above ODV? Should investors in electricity lines businesses have legitimately expected to earn a return on any price paid above ODV?

No comment.

86. How is the choice of opening asset values likely to effect investors' perceptions of regulatory risk (and therefore dynamic efficiency) going forward?

Any valuation shock will be perceived negatively and reduce industry attractiveness to capital providers. It will also create uncertainty going forward.

87. What inferences, if any, could electricity lines businesses reasonably have drawn as to the appropriate asset valuation methodology to be used for pricing, from the introduction of information disclosure in 1994?

Government statements and behaviour by its own line company Transpower since 1994 have implicitly and explicitly sanction ODV based pricing and investment return performance measures. Quite clearly the pricing from ODV was accepted if not sanction behavior for the distribution industry.

88. What impact might the introduction of Part 4A have had on investors expectations regarding asset valuation methodologies?

Part 4A creates risk and uncertainty for investors especially with respect to asset valuation methodologies given the importance of return on and of capital in this industry.

89. Which valuation methodology would best promote dynamic efficiency?

ODRC/ODV, provided issues concerning asset lives, standard replacement costs and fully depreciated assets are fully addressed.

90. To what extent is optimisation required in the case of the system fixed assets of electricity lines businesses?

Generally optimisation is of limited value on existing assets, however it places some useful discipline over new capex decisions.

91. To what extent is this optimisation being undertaken through the application of the current ODV Handbook?

Optimisation is under taken to the level necessary to comply with the current ODV Handbook.

92. Have electricity lines businesses earned excessive profits in the past?

No comment.

93. How have revaluations gains been treated by electricity lines businesses in the past?

Disaggregation of the gains by source is required before any useful comment can be made.

94. How should the issue of consistency (including the treatment of revaluation gains) influence the choice of asset valuation methodology?

Without consistency over time and between companies, the regulatory thresholds regime will struggle where it has any emphasis on excess returns and efficiency.

95. How would the Commission's choice of opening values affect the profile of expected returns under different valuation methods into the future?

This is difficult to answer definitively. However it is probable the valuation methodology will have a bigger impact on the question of returns and general tariff level than on their profiles. Use of HC creates more risks of rate shock in the future.

96. Can both ODV and DHC valuation methods deal with the issue of excess profits? What factors should be looked at in determining whether each valuation methodology has been applied consistently over time to avoid excessive profits?

DHC only has utility going forward, it has no credibility with respect to the historic asset base. ODRC/ODV is more appropriate to use for this purpose, it is an extension of the existing 'ground rules' established by the state under the light handed regulatory regime.

97. When using a nominal WACC and a replacement cost methodology, should gains due to inflation be treated as income in the year after they occur? Could they be spread over a number of years? What are the difficulties with this approach, eg, could there be a 'spiraling up' of moneys that have to be redistributed to customers in later years? Would interest need to be charged on this outstanding amount?

Use of a Nominal WACC is preferred hence those revaluation gains due to inflation should be treated as income. They should be spread forward over a number of years and TPNZ's economic value accounting methodology provides an good way of recording what is happening.

98. How difficult would it be to obtain a valuation based on a "pure" historic cost valuation? How difficult would it be to obtain a valuation based on book value at vesting plus additions and deletions valued at historic cost? Is the information available from separation or more recently? Does the quality of information available preclude the use of any opening valuation methodology?

A 'pure' historic cost valuation is unobtainable given records and historic practices used in electricity line business. Prior to corporatisation in 1993/94, no detailed asset register was maintained for systems assets. Capex and renewals expenditure is not readily identifiable and most of those records are no longer available due to the impact of successive restructuring and reforms. Vesting values for NTL were established by a DCF/capitalization of earnings basis rather than by reference to historical costs in an asset register. Therefore the vesting values reflected the tariff schedule, revenue, costs and earnings at the time and are entirely inappropriate as a proxy for historic cost.

They are also related to a wide cross section of businesses and not just the lines business.

Historic cost information is available post separation. In our opinion the quality of information pre mid 1990's excludes any possibility of recourse to 'pure' historic cost valuations.

99. On balance, what is the preferred methodology for opening valuations of distribution businesses system fixed assets? Please comment on the relative importance of the factors considered by the Commission and any other factors considered relevant.

The preferred methodology for opening valuation is ODRC/ODV. The methodology is rigorous and consistently applied, has strong theoretical under pinnings and most importantly is consistent with light handed regulatory regime that has been in place for the last decade. The state has also sanctioned ODV use by TPNZ over the last decade and

capital has been allocated to and within the distribution sector on the assumption of its continued use.

100. On balance, what is the preferred methodology for future valuations of distribution businesses system fixed assets? Please comment on the relative importance of the factors considered by the Commission and any other factors considered relevant.

On balance ODRC/ODV is preferred provided a review is undertaken on key aspects, namely, asset lives, treatment of fully depreciated assets and standard replacement costs. DHC with some indexation has merit if there are to be no enhancements made to the current ODV Handbook.

101. On balance, what is the preferred methodology for opening valuations of Transpower's system fixed assets? Please comment on the relative importance of the factors considered by the Commission and any other factors considered relevant.

To maintain consistency with other line companies, we suggest ODRC/ODV.

102. On balance, what is the preferred methodology for future valuations of Transpower's system fixed assets? Please comment on the relative importance of the factors considered by the Commission and any other factors considered relevant.

To maintain consistency with other line companies we suggest ODRC/ODV, otherwise DHC.