



Asset Valuation Methodologies

**Submission from Powerco on the
Commerce Commission's Issues
Paper**



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Executive Summary

This submission provides Powerco's comments on your Asset Valuation Methodologies Issues Paper ("the Issues Paper") as an input to the discussion paper on Valuation Methodologies that the Commission intends releasing in early July.

Our comments distinguish:

- Inter-related activities with asset valuation;
- The role of a asset valuation methodology; and
- Issues Paper questions.

We look forward to discussing these issues further with the Commission and to your forthcoming Discussion Paper. We have commented elsewhere on the thoughtful and objective analysis in the *Regulation of Electricity Lines Businesses* Discussion Paper and its constructive role in grounding the consultation process. It would be helpful if the Discussion Paper on Valuation was in the same style and addressed the concerns that we raise about the role that asset valuation plays in an integrated regulatory framework for the sector.

Powerco welcomes a fact-based Discussion Paper from the Commission on Valuation set in a broader context

Inter-related activities

Your Issues Paper identifies that the Commission is required by Part 4A of the Commerce Act to carry out this review of asset valuation methodology and that the same part of the Act requires the Commission to:

- Develop a price control regime, including thresholds;
- Conduct an asset recalibration audit; and
- Determine and administer an information disclosure regime.

Steven Boulton's letter to John Belgrave (30 April 2002) pointed out the inter-relationship between these activities and the need to integrate the process and timelines for the consultations around price control and asset valuation. In this letter we emphasised that it will be essential to settle the issue of what role asset valuation will play before any decisions are made on price control. Whilst it is Powerco's contention that asset valuation should not be a direct input to price control, if this is NOT the case then it will be essential that the issues of valuation methodology and price control are dealt with in the same process rather than the present parallel approach.

Powerco has recently made a submission to the Commission on *Regulation of Electricity Lines Businesses*, responding to the 21 March 2002 Discussion Paper. This Discussion Paper explicitly considers the treatment of revaluations (A.29) and by implication the interrelationship of a valuation methodology with thresholds for and the declaration of price control.

In this submission we address the questions raised in the Issues Paper on Valuation. In so doing, we repeat some of our comments from our *Regulation of Electricity Lines Businesses* submission where they are relevant. We anticipate that the Discussion Paper on Valuation will provide an opportunity for Powerco to develop the material presented here, in particular to provide further detail on the way in which the issues apply to decisions within our business and the way in which they would affect consumers on Powerco's network.

Valuation is inextricably linked to the use to which it will be put



The role of a valuation methodology

The Commission's questions about revaluation are in the context of its proposed "profit threshold". We attach a copy of Powerco's submission to this submission but particularly draw your attention to our answer to questions 27 to 33 concerning the "profit threshold" and the discussion of "profitability and sharing" on pp. 15 to 18 of the text.

In our submission we note a concern with the implicit assumption in the Commission's questions that "excess profits" can only be determined by comparing a risk-adjusted WACC with RoI, and hence that a valuation must be used to determine RoI.

Powerco proposes that the Commission use the legally accepted interpretation of "excessive" being "unreasonable or unjust". We provide more detail on this matter in our answer to question A.2 (Appendix 1). In so doing the Commission would avoid the many problems that beset a regulatory regime which controls company inputs and thus disempowers company management against the long-term interest of consumers and the Commission's ultimate Purpose Statement in Part 4A.

In the Issues Paper, the Commission points out that there is no purpose statement for the review of valuation methodologies. It contrasts this with its requirement to develop a price control regime, including thresholds; conduct an asset recalibration audit; and determine and administer an information disclosure regime. In interpreting the purpose for the review of valuation methodologies

The Commission considers the review could assist in formulating disclosure obligations, conducting thresholds assessments and operating control and that it should have the appropriate valuation methodology or methodologies for these tasks.¹

Powerco does not agree that asset valuation should be an input to the operation of price control. As such we believe the Commission's review of asset valuation methodology should solely be to confirm a methodology that will facilitate information disclosure.

Asset value is not an output from lines businesses and does not constitute a service. The role of an asset valuation methodology is to provide a denominator by which the information disclosed by companies, about the way that they run their businesses, can be normalised. Clearly absolute levels of expenditure on a network are not directly comparable and need to be pro-rated to the size of the asset base that they relate to – which requires a common valuation. In this way valuation would be relevant to benchmarking exercises carried out by both the Commission and the companies themselves and will contribute to the discovery of efficient cost allocations.

Valuation has no role in determining excess profits

The role of valuation is to support information disclosure

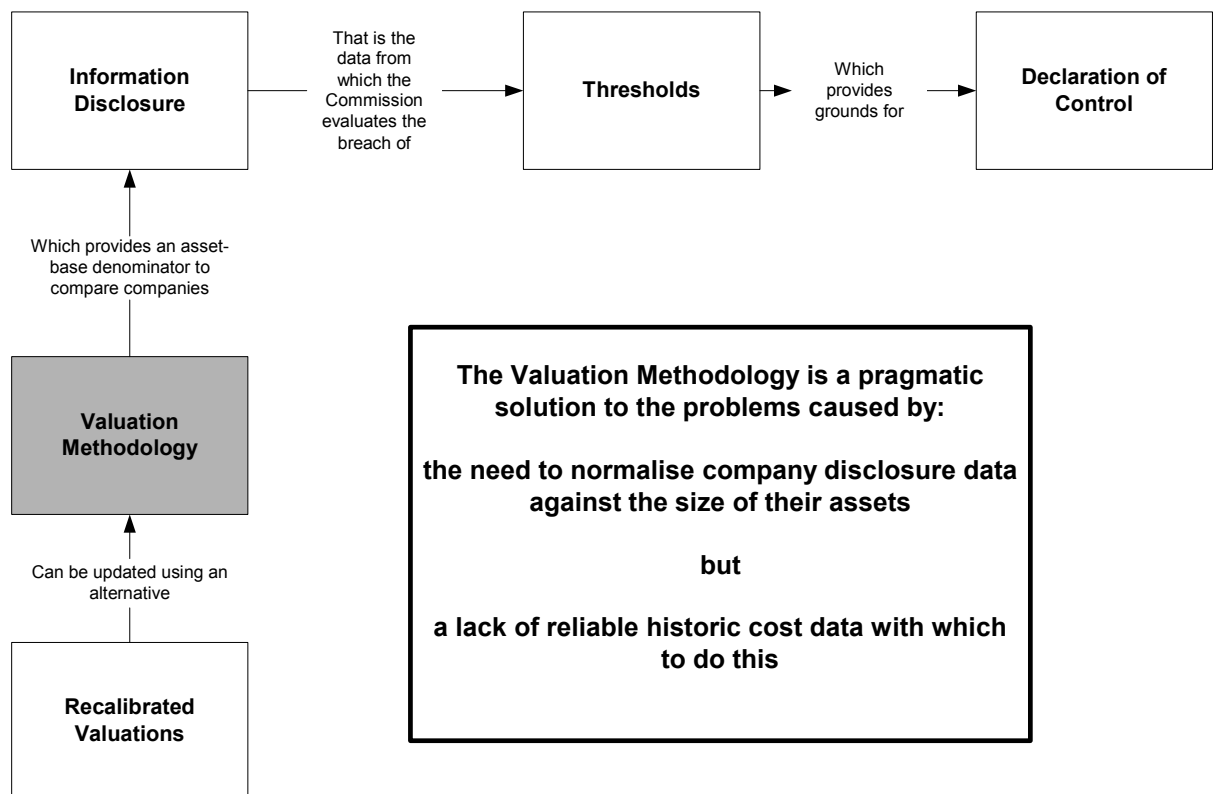
¹ Commerce Commission Issues Paper: The Review of Asset Valuation Methodologies, p.1

The role of the valuation methodology is therefore an input to the information disclosures on the basis by which the Commission is able to meet its dual obligations to create and manage regimes, i.e.:

- *to promote the efficient operation of markets directly related to electricity distribution and transmission services by ensuring that large line owners and large electricity distributors make publicly available reliable and timely information about the operation and behaviour of those businesses, so that a wide range of people are informed about such factors as profits, costs, asset values, price (including terms and conditions of supply), quality, security, and reliability of supply of those businesses.²; and thus*
- *to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers³.*

The statutory role of an asset valuation methodology is to promote the efficient operation of line markets through information disclosure and targeted control

The relationship between the valuation methodology review and the Commission's other roles in Part 4A is shown below:



² Commerce Act 57T(1)

³ Commerce Act 57E



There is no evidence in New Zealand legislation or in Cabinet Paper FIN (00) 238 relating to the new Part 4A of the Commerce Act that the declaration of control was intended to be derived from the valuation methodology determined under the review specified in Part 4A.

We reproduce below Powerco's answer to question 29: *How should the Commission treat revaluations and devaluations for the purposes of evaluating whether a business has, over time, made excessive profits?*

- *Asset valuations should not be used at all in determining whether profits are “excessive”. We suggest that it be judged on the legal principles of equity and good conscience instead.*
- *The role of a valuation methodology is to provide a normalised denominator for the comparison of company performance where historic cost data is not available.*
- *This question implies that the Commission will measure RoI, calculated using an asset value, to assess whether profits are excessive.*
- *WACC – and whether profits exceed it – should not be the measure for whether or not profits are excessive. See our answers to A.2, A.8, A.9, A.27 and A.28.*
- *Historic cost data is not of a sufficient quality to measure RoI over a 30 year period.
Any attempt to reduce RoI to WACC over a shorter period than the life of an asset will increase the cost of capital and drive investment from the sector.*
- *This is dynamically inefficient and inconsistent with the Purpose Statement.*
- *Valuation methodologies, such as ODV, provide a normalised denominator for the comparison of company performance where historic cost data is not available.
They are not appropriate as a building block for a threshold of price control as investors will not accept a WACC-related return on a long-life asset if there is a risk that the asset will be economically stranded before they have recovered their capital investment.*
- *Historic cost is the only valuation relevant to a comparison of profit with WACC.*
- *If profit is used as a supporting indicator of trends in company performance (see A.28), revaluation effects can be smoothed by averaging asset values over a five year period.⁴*

⁴ Regulation of Electricity Lines Businesses, Submission on the Commerce Commission's Discussion Paper from Powerco, 24 May 2002. pp. 48-49

Issues Paper Questions

Our short-form answers to the detailed questions in the Issues Paper are:

Answer Reference	Question	Powerco's response
1	<i>What should be the purpose(s) of the review, having regard to the purpose of the Act and the purposes of the other subparts under Part 4A?</i>	<p>To identify a methodology against which base line business asset values can be assessed in the absence of adequate historic cost information on, or before, 31 March 2001 being the valuation date used for the Commission's recent recalibration exercise⁵.</p> <p>Inputs from the asset recalibration exercise would be applied to this methodology.</p> <p>Future investments should be valued at replacement cost (as defined in the ODV Handbook).</p>
2	<i>Can one valuation methodology be used for different purposes (e.g. comparative benchmarking and assessments of electricity lines businesses against control thresholds) or are different valuation methodologies best used for different purposes?</i>	<p>A single valuation methodology can be applied for different purposes to facilitate the interpretation of disclosed information.</p> <p>It is not appropriate for the Commission to use an asset valuation, derived by a methodology or any other mechanism to determine prices.</p>

⁵ Commerce Commission, Asset Recalibration Document, 28 September 2001, *Recalibration Of Asset Values Of Large Electricity Line Owners By Comprehensive Audit*

Answer Reference	Question	Powerco's response
3	<p><i>What assets should be valued (e.g. the entire business, a business unit, a regional business unit)? Does the reference to "system fixed assets" in the Act mean that the definition in the Electricity (Information Disclosure) Regulations 1999 should be used for the review? Does it mean that only specialised assets (or sunk assets) of electricity lines businesses are covered by the review?</i></p>	<p>Some of the assets on Powerco's network provide a service that is shared by many consumers. It is these assets to which Part 4A applies and which should be valued.</p> <p>Other spur assets are covered by direct contracts between one or several beneficiaries. The services provided by these assets are discretionary and elective (i.e. not shared). Part 4A does not apply to these assets and they should not be subject to an asset valuation methodology.</p> <p>The methodology has nothing to do with organisational structures or business units – it relates to regulated assets only.</p> <p>Powerco incurs costs through negotiating access with landowners, obtaining Resource Consents etc., some of which are capitalised. The ODV Handbook does not include these costs in asset value, despite the fact that they relate to the capital cost of providing the infrastructure. The asset valuation methodology should include non-tangible assets such as easements and other ancillary outcomes, which contribute to the service delivery through the physical assets.</p>
4	<p><i>How important is it that the valuation methodology used in the electricity industry be consistent with approaches in other industries? What matters should be treated consistently? What matters should be treated differently?</i></p>	<p>The role of the methodology is to provide a proxy for historic costs when reliable data is not available.</p> <p>Historic cost data is notably unreliable in the case of electricity distribution businesses in New Zealand due to past constraints and the inconsistent accounting practices of precedent organisations (i.e. power boards and MED's).</p>
5	<p><i>What valuation methodologies should be considered by the review?</i></p>	<p>ODV and its inputs (RC, DRC and ODRC) and combinations thereof e.g. a foundation of ODV with additions at replacement cost (as defined in the ODV Handbook).</p>

Answer Reference	Question	Powerco's response
6	<i>What are the underlying economic and accounting rationales for each methodology? Are these rationales relevant for electricity lines businesses?</i>	The only relevance of ODV and its inputs is the stability of company processes and proven operation of the methodology in New Zealand's lines businesses.
7	<i>What are the pros and cons of each valuation methodology? How important are these in the context of the regulation of electricity lines businesses?</i>	Administration cost for a one-off methodology-derived valuation. Future investments should be valued at replacement cost (as defined in the ODV Handbook). This would provide for consistency without the need for expensive valuation exercises such as ODV.
8	<i>What are the information requirements of each valuation methodology? What detail of information is required? How accurate and robust is the information likely to be? What are the costs of developing and obtaining it?</i>	An ODV valuation requires considerable data storage, retrieval, processing and analysis. The optimisation and economic value processes in particular consume a huge amount of resource incurring high costs, for which consumers ultimately pay but receive very little benefit. Incremental investment at replacement cost with annual depreciation would be much simpler and cheaper to administer for both the Commission and lines businesses.
9	<i>How might different valuation methodologies (in conjunction with the regulatory controls) affect the incentives and ability to invest of electricity lines businesses?</i>	Any valuation, which is used as a building block for a price control, will distort investment incentives around the operation of the valuation methodology. Powerco has argued in its regulation submission that the risk to capital recovery posed by any optimisation-based methodology used in this way cannot realistically be recovered by an adjustment to WACC and so deters investment. ⁶

⁶ Regulation of Electricity Lines Businesses, Submission on the Commerce Commission's Discussion Paper from Powerco, 24 May 2002. A. 18 pp. 44

Answer Reference	Question	Powerco's response
10	<i>Can valuation methodologies impact on the pricing of electricity line business services? If so, what relevance does this have for the choice of valuation methodology?</i>	Valuation should not be used as an input to drive price or establish price paths. Pricing should be a function of transparent consumer preference survey, reconciled with company asset management planning and efficiency benchmarking. See Powerco's regulation submission. ⁷
11	<i>How important are the types of assets, such as specialised (or sunk assets) and non-specialised assets, to the choice of valuation methodology?</i>	Standard replacement costs are not appropriate in some cases, such as specialised assets or installation in unusual locations. The valuation methodology needs to recognise this to allow the actual establishment costs to be used where this is reasonable.
12	<i>On what basis would optimisation of electricity line business assets be an appropriate feature of asset valuation? How should optimisation be interpreted (e.g. modern equivalent assets, removing redundant assets, removing assets that are not used or useful)? With which asset valuation methodologies can optimisation be used, and why?</i>	<p>Any valuation, which is used as a building block for a price control, will distort investment incentives around the operation of the valuation methodology.</p> <p>Powerco has argued in its regulation submission that the risk to capital recovery posed by any optimisation-based methodology used in this way can not realistically be recovered by an adjustment to WACC and so deters investment.⁸</p> <p>Optimisation is intended to discipline over-investment through affecting an asset-based revenue requirement. We propose a process-based approach for determining regulated revenue, where consultation, transparency and audit discipline over-investment and assets are safe-harboured at replacement cost once sunk. In this model, optimisation serves no useful purpose.</p>

⁷ Regulation of Electricity Lines Businesses, Submission on the Commerce Commission's Discussion Paper from Powerco, 24 May 2002. pp. 24-28

⁸ Regulation of Electricity Lines Businesses, Submission on the Commerce Commission's Discussion Paper from Powerco, 24 May 2002. A. 18 pp. 44

Answer Reference	Question	Powerco's response
13	<i>How successful has the ODV methodology been at facilitating comparative benchmarking of electricity lines businesses?</i>	The methodology is well understood and the rules are well implemented in New Zealand – witness the results of the Commission's recent recalibration audit. Any shortcomings of the present information Disclosure Regime are largely due to the lack of analysis and communication of comparative data to consumers. Powerco in its price control submission proposes that the Commission should fill the role of identifying for consumers those companies that are performing as well as those that fall short of the required standards.
14	<i>What is the relevance of ODV Handbook to the review? Does the current ODV Handbook encourage sound application of the principles of ODV? If not, how could the ODV Handbook be improved? Should a similar handbook be developed if another methodology is preferred?</i>	ODV and its inputs are pragmatic alternatives to historic cost for currently sunk assets where records do not exist. The ODV Handbook has evolved to a point where it is being applied to a reasonably consistent standard as the recent audit determined. There is always room for improvement however and the methodology adopted should include regular reviews of any source reference such as the Handbook.
15	<i>What would be the transition costs of changing from ODV to a refinement of the ODV methodology or to an alternative valuation methodology?</i>	This could potentially be high and with no long-term benefit to consumers depending on the complexity of the methodology chosen.
16	<i>What lessons from overseas (in the electricity industry and other industries) should be considered in the choice valuation methodology?</i>	Intrusive regulation leads to a deterioration of end-consumer value in the longer term and the use of valuation by regulators making decisions on behalf of company management is not in the long-term interest of consumers.

Answer Reference	Question	Powerco's response
17	<i>Do the prices at which electricity assets have been traded in the market (e.g. in takeovers or acquisitions) have any relevance for the choice of valuation methodology?</i>	<p>The sale and purchase of electricity distribution businesses at values in excess of ODV illustrate the point that the ODV process does not include all the assets associated with the delivery of line function services (see answer 3 above).</p> <p>Utilising ODV multiples is misleading in terms of debate about the inherent value of a business. Commercially prudent business executives would not utilise ODV multiple as the decision making tool for determining a business value.</p>
18	<i>Should the size of an electricity lines business affect the choice of valuation methodology?</i>	No.
19	<i>Should the ownership structure of an electricity lines business (e.g. public company, private company, or trust) affect the choice of valuation methodology?</i>	No.
20	<i>Should valuation methodologies differ for assets that are the subject of explicit service contracts and assets that are not?</i>	Any dedicated asset subject to a direct contract is not within the scope of Part 4A. See answer to question 3.
21	<i>Should valuation methodologies differ for assets that are currently in service contracts and assets that are not?</i>	Any dedicated asset subject to a direct contract is not within the scope of Part 4A. See answer to question 3.
22	<i>How should valuation methodologies treat assets that may be used (in part) for purposes other than conveying electricity (e.g. telecommunications) or in non-controlled electricity activities?</i>	Methodology is solely a proxy for historic cost and so other uses are irrelevant.

Answer Reference	Question	Powerco's response
23	<i>Should asset valuations be audited? If so, how should this be done and by whom?</i>	Yes. A qualified auditor appointed by the lines company but subject to disqualification an agency such as the Commission.
24	<i>Are there any other matters that should be considered by the review?</i>	See main body of submission.