



**Reply on various issues arising at the conference on
the Review of Asset Valuation Methodologies**

5 December 2002

1. INTRODUCTION

The Commission has invited further submissions on issues raised at the conference on the review of asset valuation methodologies which might otherwise be addressed by way of an oral reply.

The three issues on which VECTOR/UnitedNetworks wish to comment are:

- The interpretation of section 57E of the Commerce Act, and in particular:
 - the reference to "*excessive profits*" in sub-paragraph (a) of that section;
 - the requirement that the regime under Subpart 1 of Part 4A of the Commerce Act be targeted;
- The extent to which VECTOR/UnitedNetworks proposed international benchmarking thresholds meet Commission concerns including limiting excessive profits; and
- The use of asset valuation methodologies under different stages of the targeted control regime.

Some of these matters are outside the scope of the review of asset valuation methodologies. The Commission, however, put these matters to parties at the conference and has stated that it intends releasing a high-level paper on its proposed thresholds in December 2002.

2. INTERPRETATION OF SECTION 57E OF THE COMMERCE ACT

At the conference, the Commission commented a number of times on the interpretation of the purpose statement in section 57E of the Commerce Act:

- In questions to VECTOR/UnitedNetworks, the Commission referred to the reference to "*excess profits*" in section 57K of the Commerce Act and questioned whether this required the Commission to set a standard asset valuation methodology in order to identify *excess profits* (transcript, 25 Nov., pp. 68 – 69);
- In statements to Dunedin Electricity and in exchanges with Powerco, the Commission appeared to take the view that it is required to identify excessive profits at the threshold setting stage (transcript, 27 Nov., p. 33 and 28 Nov., p. 9)

VECTOR/UnitedNetworks note that Powerco also submitted that section 57K is mainly intended to apply post threshold and is focused on process. Powerco also submitted that the sub-paragraphs (a) – (c) of section 57E are not to be interpreted mechanistically (transcript, 28 Nov., pp, 5, 6 and 9).

In response, VECTOR/UnitedNetworks submit that:

- Our written submission on the Commission's asset valuation methodologies discussion paper of 2 October 2002 made submissions on the purpose of the review and the criteria that the Commission should use in conducting the review (see section 2 and Appendix 1).
- Our earlier submissions on the Commission's thresholds discussion paper of 21 March 2002 (including at the July conference and in rights of reply) made extensive submissions on the interpretation of section 57E. The companies confirm their view that the statutory purpose of the control regime is economic efficiency, and that it be targeted, and that thresholds should be set consistent with this overall purpose.

- In particular, we confirm our view that sub-paragraphs (a) – (c) of section 57E are not to be interpreted in isolation. Rather, these sub-paragraphs are to be considered by the Commission in carrying out its functions under Subpart 1 of Part 4A in accordance with the overarching efficiency purpose. The Commission must not interpret these provisions in isolation from this statutory purpose, or place undue weight on any particular sub-paragraph. Rather it must take these sub-paragraphs into account in its overall design of the targeted control regime in a manner that best gives effect to the statutory purpose. The Commission’s apparent focus on “*excessive profits*” means that the Commission could give undue weight to sub-paragraph (a) at the expense of compliance with the statutory purpose.
- Section 57K is only about the prioritisation of the Commission’s tasks. It does not create any substantive obligations, and does not detract from the statutory purpose and our view that thresholds should be set consistent with the overall efficiency purpose.
- We confirm our oral response at the conference and agree with Powerco’s oral submission that section 57K is mainly, if not entirely, directed at prioritisation post-thresholds. Sub-section (1), although it states that it is “without limitation” describes only Commission tasks that occur after threshold-setting. The companies note that this appears to have been recognised by the Commission in its 21 March Discussion Paper on the proposed thresholds, where the Commission discusses section 57K in the context of making assessments and declarations of control. In any case, there is no need for the Commission to prioritise its tasks in the setting of thresholds as it should be possible for the Commission to set thresholds that apply to all companies at the same time.
- The companies note that the Commission did not in its thresholds discussion paper or its asset valuation methodologies discussion paper refer to section 57K as a basis for requiring the Commission to identify *excess profits*.
- The matters in sub-section (2) of section 57K, other than the specific requirement to consider the purpose statement, are clearly expressed to be optional considerations. There is no requirement, even if the Commission were to prioritise its threshold-setting tasks, that it take into account the “*extent of any excess profits*” or any of the other matters in sub-paragraphs (a) – (d).

On a related matter, if the Commission were to set thresholds that focused on excessive profits (for example through a rate of return based threshold), the Commission would thereby effectively establish a *de facto* universal control regime. As stated in previous submissions from the companies, the use of intrusive rate of return measures is a distinguishing feature of universal control regimes. The setting of such thresholds would be completely contrary to section 57E, which states that the purpose of Subpart 1 is to be achieved through “*targeted control*”.

3. BENCHMARKING AND LIMITING EXTRACTION OF EXCESS PROFITS

The Commission, in questioning WEL on its submission that the Commission abandon its excessive profits criteria (for the review), raised doubts (in relation to excessive profits or prices) about the adequacy of international benchmarking measures as thresholds. Even though the Commission noted that such thresholds may be the “lowest, cost effective way”, the Commission raised concerns about picking a point in a large range and having still to look at “cost drivers” in New Zealand and overseas (transcript, 27 Nov., pp 29-31).

In addition to VECTOR/UnitedNetworks’ international benchmarking proposals, we note Powerco’s oral submission to the conference submitted that rather than taking a mechanistic approach to sub-paragraph (a) of section 57E and trying to identify excessive profits, the Commission should focus on developing a “*scheme that gets rid of them*”

(transcript, 28 Nov., p. 11). Other submitters (e.g. PWC, WEL) have emphasised the need for the Commission to focus on prices and service quality (i.e. outputs rather than inputs).

VECTOR/UnitedNetworks have yet to receive the Commission's comments on their international benchmarking proposal, which might clarify the basis for or nature of the Commission's apparent concerns. However, we respond in general terms below.

In VECTOR/UnitedNetworks' view, international benchmarking of price and service quality and current prices best meets the considerations of the purpose statement including limiting lines businesses from extracting excessive profits. As described in UnitedNetworks' *Response to issues raised by the Commerce Commission on UnitedNetworks' Proposed Regulatory Thresholds for Electricity Lines Businesses* dated 16 September 2002, the use of internationally benchmarked prices is likely to provide more reliable estimates of efficient New Zealand prices, and at much less cost, than if the Commission were to derive them itself.

In addition, setting price thresholds at the lower of internationally benchmarked prices and current prices would have the dual effect of:

- Revealing those lines businesses which are charging in excess of their international peers; and
- Preventing those already charging less than their peers from raising their real prices.

The threshold price levels and the cost efficiency of the firm would therefore determine the profitability of lines businesses. The thresholds would thereby limit the ability of lines businesses to extract excessive profits through charging excessive prices or providing inferior service.¹ Through the updating of the thresholds, NZ consumers would be kept up to date with service and price level improvements achieved in comparable markets, and should be confident they are getting as good a deal or better than their international peers.

The issue of "picking a point" is just one particular issue to be considered in implementing a benchmarking methodology. The wider issue is whether the benchmarking methodology can be credibly implemented. The benchmarking approach outlined in UnitedNetworks' submission of 16 September 2002 has been reviewed for its implementability by an electricity benchmarking expert (Pacific Economics Group)² and an experienced New Zealand public policy expert (Mr Paul Carpinter).³ We would refer the Commission to the report by Pacific Economics Group as to why they consider the proposal could be implemented readily.

The two primary cost drivers determined by customers are customer density and energy density.⁴ Our threshold proposal accounts for these cost drivers by dividing distribution services provided by lines companies in New Zealand into different bands of consumer and energy density and comparing the price and service levels for these services to the price and service levels of distribution services provided by companies in other jurisdictions within the same consumer and energy density bands.

¹ The appendix to this report contains a description of the limits placed on lines businesses' ability to earn excessive profits through excessive prices or inferior service

² *"Regulatory Thresholds for Electricity Lines Businesses in New Zealand: The Merits and Feasibility of UnitedNetworks' Proposal"*, Dr. Lawrence Kaufmann, Pacific Economics Group, September 2002

³ *"Review of UnitedNetworks' Proposal for the Regulation of Electricity Lines Businesses"*, Paul Carpinter, 23 September 2002

⁴ For analysis of consumer and energy densities and their implications for cost, see Appendix 6 of the 16 September 2002 submission from UnitedNetworks. The cost analysis in this appendix was peer reviewed by Dr John Small of Covec Ltd

The companies note that the Commission itself in its thresholds discussion paper states that a price path (without a profit threshold) would limit the ability of businesses' to make excessive profits over time and could potentially substitute for profit thresholds (paragraph 8.24). We agree. A price path set by benchmarked thresholds would be a proper substitute for any profit threshold, given the statutory purpose of the targeted control regime.

4. USE OF ASSET VALUATIONS UNDER DIFFERENT STAGES OF THE TARGETED CONTROL REGIME

At the conference, the Commission questioned VECTOR/UnitedNetworks about the use of asset valuations at different stages of the targeted control regime.

VECTOR/UnitedNetworks confirm their view that there is no need for valuations to be used in the setting of thresholds. The Commission can, and should, set thresholds that do not require asset valuations. We note that other submitters supported quality and price thresholds that would not require asset valuations (e.g. PWC, PowerCo, WEL). We also note that WEL (transcript, Nov. 28, p32) Dunedin Electricity (transcript, Nov. 27, p51) and Powerco (transcript, Nov. 27, pp15-16) acknowledged that valuations could be used at the investigation and control stage.

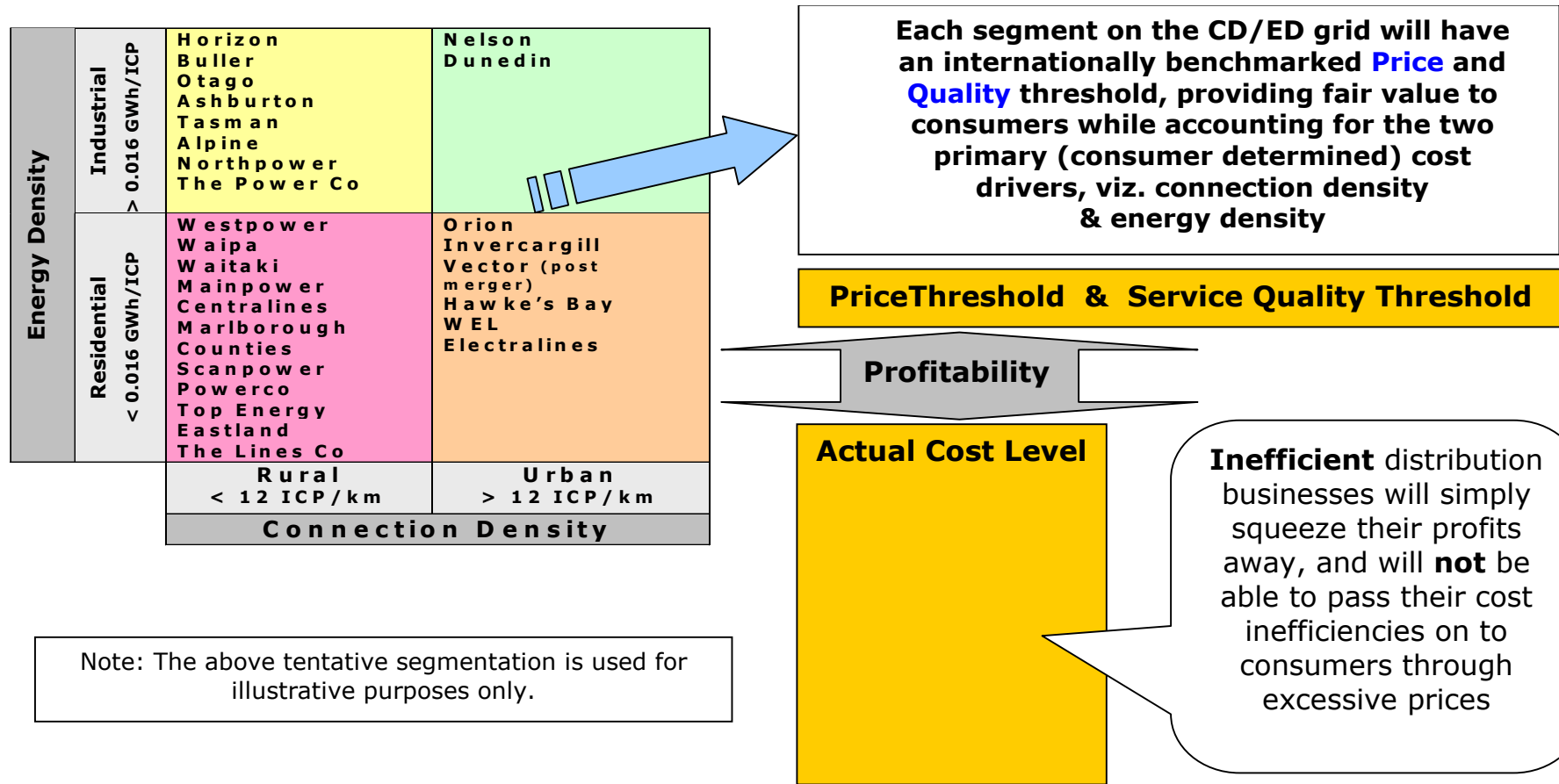
This issue has not been explored in any detail in the asset valuation methodologies discussion paper. The companies note that the asset valuation methodologies discussion paper only refers to asset valuation input into its "control decisions" (p. 19). Apart from that, it generally discusses the valuation for "regulatory control" which is vaguely specified. The Commission's thresholds discussion paper suggested one instance, i.e. a building block approach to CPI-X control, which could involve asset valuations.

As discussed in the accompanying overview paper on the *Design and Implementation of the Targeted Control Regime for Electricity Lines Businesses*, in investigating a breach of a threshold the Commission's investigations could cover a wide spectrum, from relatively straightforward investigations that establish a service impairment was due to, for example, a freak weather incident, to extensive investigations related to price, service levels and trade-offs between them. Such investigations may include assessing price levels with reference to an appropriate return on the asset base of the lines business. This would require a value to be placed on that asset base.

We also accept that in the event of control of an individual company's goods and services being declared, it would be open to the Commission to adopt an approach to control of that company's prices for those goods and services that required the consideration of asset valuations at the commencement of and during control. Whether that would be warranted is a separate question governed by the application of the purpose statement to the circumstances.

If asset valuations are considered either in the course of an investigation or in making a control decision the Commission could use the asset valuations disclosed under the Commission's information disclosure requirements (or the information disclosure regulations, as long as they remain in place) or could require additional information to be provided. The Commission has powers under the Commerce Act to obtain additional information it requires for declaration investigation purposes.

In accordance with our written submission of May 2002 on the review of asset valuation methodologies, we consider that the Commission should consult further at a later stage on the making of declaration and authorisation decisions. Those matters are not the subject of the required consultation process on thresholds. Each of these two functions (declaration and control) also have their own prescribed processes under the Act in relation to the individual companies directly affected and other interested individuals and organisations.



So How Can Businesses Seek to Increase Profits?		
By increasing price? ❌	By reducing quality and therefore needed investment, thus compromising sustainability? ❌	By reducing cost appropriately via economies of scale & specialisation, managerial & technical innovation, smart & frugal management? ✅
❌ Cannot increase price above the (fair value) threshold ❌ If existing price below threshold at outset, then existing price becomes threshold (i.e. no taking up of price slack)	❌ Cannot reduce quality to worse than threshold ❌ Cannot risk under-investing else quality thresholds will not be achievable on sustainable basis	✅ Diligent cost efficiency is the only avenue open to enhance profitability ✅ If enhanced efficiency is international trend as well, then periodic re-setting of thresholds will effectively redistribute benefits in favour of consumers