

**Presentation by
Unison Networks Limited
on
the Draft ODV Handbook**

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Opening Comments

- The draft Optimised Deprival Valuation (ODV) Handbook improves on the MED ODV Handbook by updating the standard asset values and the treatment of certain types of system fixed assets. However, Unison does have concerns with the transparency of the rate calculations in the new Handbook.
- Also, it is inherent in the ODV methodology and the preparation of an ODV Handbook that there will be limitations that need to be recognised when using the ODV of a lines business's system fixed assets.
- Part 4A represents a (potential) material change from the previous use of the ODV in the information disclosure regime – simply modifying the existing handbook is insufficient to meet the purposes of Part 4A.
- Where the ODV is used in the *regulation* of electricity lines businesses, its use must be consistent with the Purpose Statement of part 4A of the Commerce Act.



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Outline of this presentation

- Use of the ODV
- The ODV methodology
- Practicality of building or replacing a network at ODV-equivalent cost
- Improvements to method of determining standard asset values
- Implications for the use of ODV
- Investment incentives
- Conclusions



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Use of the ODV

- The Draft ODV Handbook “details the ODV methodology that large electricity lines businesses ... are required to use when valuing their system fixed assets on an ODV basis for the purposes of Part 4A of the Commerce Act 1986”
- Historically the ODV has been used for information disclosure purposes but not for determining efficient costs or revenues.
- If ODV is an input to determining efficient costs or revenues, it should be noted that the ODV relates only to system fixed assets and not to the total assets employed by a lines business.
- A new ODV Handbook developed for the purposes of Part 4A should provide principles of valuation that recognise efficient investment, such as in the FRS-3 approach.



ODV Methodology

- The ODV methodology calculates an idealised value of a lines business's system fixed assets
 - First it values existing system fixed assets at the replacement costs (RC) of Modern Equivalent Assets (MEA)
 - Then it optimises the existing network to one that has the service potential the lines business “reasonably requires” to calculate the Optimised Replacement Costs (ORC)
 - It may also calculate the Economic Value (EV) of certain system fixed assets or groups of system fixed assets
 - The ORC and EV are then depreciated to reflect the age of the existing system fixed assets



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ODV is lower than practically achievable costs

- The standard values in the ODV Handbook of the replacement costs of MEAs are determined using the most optimistic possible assumptions
- Determination of the optimal configuration of a network with the benefit of hindsight does not reflect the actual conditions under which current and future investment decisions need to be made by lines businesses
- Taken together these mean that ODV in aggregate will always be lower than actual achievable cost



Changes to method of determining standard asset values

- **Lowest replacement cost or lowest lifetime cost?** By limiting the planning horizon (to between 0 and 15 years) to less than the asset lifetimes (of between 20 and 50 years) using assets with lowest replacement cost may result in higher lifetime cost.
- **Standard Modern Equivalent Asset (MEA) values in the draft ODV Handbook are based on the lowest possible costs and assume “purchasing all items (equipment and services) at the best possible rates”.**
- **In practice rates will vary according to market conditions at the time and the “best possible rates” achievable by a lines business may differ from those assumed in calculating the standard MEA value.**
- **Asset Management Plan forward projections are based on current day construction costs and incorporate the full cost of construction.**
- **It would be more appropriate to use:**
 - **Assets with the lowest lifetime costs where these differ from the assets with lowest replacement costs**
 - **Median or mean of a range of values (instead of the lowest possible value)**



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Implications for use of ODV

- In applying the ODV Handbook the following limitations must be recognised:
 - It is impractical for a lines business to reconfigure its network if it differs from the optimal configuration
 - The method of determining standard values proposed in the draft ODV Handbook means that the ODV represents the lowest possible value of a lines business's system fixed assets
 - Actual costs will differ from the standard values from time to time according to conditions in the markets for equipment and services



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Investment Incentives

- **A lines business would not invest in a system fixed asset if it could only recover the ODV of the asset and:**
 - the lowest cost it could achieve in a competitive tender exceeded the ODV; or
 - there was a possibility that the asset would be optimised down (or out) at a later date and there was no provision for recovering the write-down costs
- **Investment by a lines business is efficient provided that at the time of the investment:**
 - the lines business has obtained the lowest possible cost through a competitive tender process
 - the need for the investment is supported by reasonable expectations of consumer demands



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Conclusions

- The ODV calculates a value for a lines business's system fixed assets based on assumptions that are not achievable in practice
- The efficient costs of building or replacing system fixed assets will generally be higher than the ODV of those assets but the ODV of a network in total will always be higher than actual efficient costs
- These factors need to be taken into account when using ODV for any application under part 4A of the Act
- Unison favours a principled approach (such as the FRS-3 approach) to valuation as opposed to an ever increasingly prescriptive approach
- It would be inconsistent with the purposes of part 4A of the Act if lines businesses were discouraged or prevented from installing or replacing system fixed assets simply because the costs exceeded ODV



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