UCLL & UBA Conference issues

Working paper, 19 May 2015

1 Introduction

This short note addresses the following issues raised at the Commerce Commission's conference on UCLL and UBA Final Pricing Principle, held in Wellington in April 2015:

- The suitability of the Palmerston North exchange for sampling
- The relevance of the Eastern Australian Pipeline case for asset valuation
- The provision of a reference for NIPA.

2 Palmerston North: suitable as a sample?

Chorus had provided the Commission with traffic data from the Palmerston North exchange. The data encompassed a unspecified four day period. Chorus claimed that it believed that Palmerston North would be suitably representative, with a student population, a mix of urban and rural, and around 30 000 end-users.

It is doubtful that any one exchange could be typical of nationwide behaviour. We would therefore recommend expanding the sample to encompass a small number of exchange locations in large urban cities, towns and rural areas.

It is also unlikely that a single four-day period would be illustrative of average usage. The data may be subject to seasonal or day-of-week effects (especially if there is a large student population), or it may include irregular or one-off events which could distort traffic patterns.

3 Eastern Australian Pipeline case

We are unclear as to the relevance of the Eastern Australian Pipelines (EAPL) case to the UCLL and UBA FPP. This case was cited by CEG at the Conference.

The EAPL case was a dispute regarding the method adopted by the ACCC to calculate the DORC. This was in the context of Australian electricity and gas pipeline regulation which involves setting appropriate compensation for actual planned investment. Contrary to CEG's claims this is not consistent with our legislative environment.

In 2003 EAPL made an application to the Australian Competition Tribunal (ACT) regarding the ACCC's determination. At that time, the ACCC usually applied straight line depreciation to obtain the DORC from the ORC, however in the case of EAPL the ACCC had employed an unusual method – a "kinked" straight line depreciation – which was rejected by the ACT. The ACCC had:

> …adopted a value for the ICB [initial capital base] of $559 million based upon adjusting ORC according to the useful asset life assumed in the past (50 years) coupled with future depreciation on the current assumed life (80 years). In each case straight line depreciation was utilised…
>
> The reasoning of the ACCC as to the ICB in the Final Decision and the Final Approval has been subjected to a number of detailed criticisms which were responded to in corresponding detail. However, it was contended that it was a fundamental error in principle for the ACCC to put aside known valuation methodologies and devise a methodology of its own which adjusted ORC in a novel fashion. It was submitted that this had no support in the Code or the material on the subject received by the ACCC and is properly described as idiosyncratic. In our opinion that submission is correct.[1]

The ACT's judgement stated that depreciation should be based on NPV calculated in relation to cost, and the WACC should be determined based on revised assumptions (namely ten year bond rate and BBB credit rating).

---

1 Australian Competition Tribunal (2004), *Application by East Australian Pipeline Limited [2004] ACompT 8*,8 July 2004, paragraphs 23 and 25.

The ACT found that a key issue in the case was the method used to calculate depreciation, and was critical of the use of straight line depreciation.

> If we were satisfied that straight line depreciation should be used to deduce DORC from ORC we would be inclined to avoid further delay in the matter and fix the ICB based upon DORC ourselves. However, in our opinion the theoretical underpinning of DORC has progressed over the years to the point where it can now be recognised that straight line depreciation is too crude a tool to be used where there is the opportunity for a more sophisticated analysis. In our opinion, the materials before the ACCC, including its own Draft Statement of Principles, recognise that a net present value (NPV) approach is required for the most reliable result to be achieved, albeit, in our opinion, based upon costs rather than revenue.[2]

The ACCC then appealed the ACT's decision to the Full Court of the Federal Court, which upheld the ACCC's approach.

EAPL appealed the Federal Court's decision to the High Court, which found that the Full Federal Court should not have set aside the ACT's decision, as the ACCC was not correct in putting aside the methodology for determining the initial capital base as specified in the Gas Code.

It should be noted that the ACCC subsequently dropped DORC, in favour of depreciated historic cost, from its regulatory principles.

> With respect to valuation of sunk assets, in the DRP the ACCC advocated that the asset base should be periodically revalued on a depreciated optimised replacement cost (DORC) basis.
>
> However, periodic revaluation of sunk assets can lead to significant variations in the value of sunk assets due to differences between asset replacement costs and historic costs.

2 Australian Competition Tribunal (2004), *Application by East Australian Pipeline Limited [2004] ACompT 8*,8 July 2004.

> Revaluations can lead to unpredictable revenues and prices, and the prospect of windfall gains or losses. Periodic revaluation can also create a risk that efficient expenditure may not be recoverable. This may deter efficient investment.
>
> For these reasons, the ACCC considers that the periodic revaluation of sunk assets should not be continued. The ACCC will now roll forward the value of sunk assets at their depreciated historic cost, taking account of inflation.[3]

Thus one of the main reasons the ACCC changed its costing approach was the possibility of windfall gains or losses. However CEG argues that such windfalls will not occur as the use of DORC gives the same result as ORC when a tilted annuity formula is applied. This outcome is indeed possible but relies on the choice of depreciation rate in the DORC calculation. Consequently CEG's claims appear simply to be an argument that sunk assets with remaining economic lifetimes should be depreciated in line with the value of modern equivalent assets.

4 NIPA reference

In relation to RSPs driving innovation in fibre product development the relevant reference is the Network Infrastructure Project Agreement (2011) between Crown Fibre Holdings and Telecom. This is available at: http://www.crownfibre.govt.nz/wp-content/uploads/2011/12/Network-Infrastructure-Project-Agreement-NIPA-24-May-2011.pdf and the relevant section may be found at Point 5 of Schedule 2 (Uptake assistance).

[3] Australian Energy Regulatory (2004) *Statement of principles for the regulation of electricity transmission revenues — background paper*, 8 December 2004, page vii.