

8 May 2006

Network Performance Group  
Commerce Commission  
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By email: [electricity@comcom.govt.nz](mailto:electricity@comcom.govt.nz)

Dear Sir/Madam

**Orion New Zealand Limited – Submission on the Commerce Commission’s paper  
“Methodology for Rolling Forward the Regulatory Asset Base for System Fixed Assets”**

**Introduction**

The purpose of this submission is to provide Orion New Zealand Limited’s (Orion) comments on certain matters raised within the paper issued by the Commerce Commission on 13 April 2006 entitled “Methodology for Rolling Forward the Regulatory Asset Base for System Fixed Assets “ (“the paper”).

We note that responses to the paper have been called for over a very short period of time, and we are disappointed that our request for an extension to enable us to undertake a more in-depth review was declined.

In general, we support the overall approach to determine the valuation of system fixed assets which the Commission has proposed in the paper as well as a number of the key decisions outlined both in the paper and the Decision Paper<sup>1</sup> (“the decision paper”) which accompanied it.

However, we also have a number of points of concern, particularly relating to the excessively high level of detail that the Commission has proposed for the implementation of the roll-forward as outlined in the paper, and other concerns which are of a more general nature. We believe that the cost to provide some of the proposed detailed information outweighs any benefits which may arise from the proposed disclosure.

**Support for elements of the proposals**

In particular, we support:

- the move to a five-yearly revaluation cycle<sup>2</sup>
- the principle of a “roll-forward” of values in intervening years, although as outlined below we have some concerns regarding the excessive level of detail proposed for

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<sup>1</sup> *Valuation of the Regulatory Asset Base (implementation Matters) for Distribution Line Businesses - Decision Paper*, 13 April 2006

<sup>2</sup> Decision paper – para 24

various disclosures, and see that we will have some difficulty in complying without considerable effort

- the removal of the requirement to provide ODV information in the intervening years<sup>3</sup>
- the commitment to update the ODV Handbook prior to each revaluation cycle<sup>4</sup>. However, we note again our concerns that Handbook asset replacement costs typically fall below the “actual”
- indexation at CPI in the intervening years<sup>5</sup>. This is consistent with the recommendations we have made in previous submissions<sup>6</sup>
- the inclusion of actual costs of capital expenditure in intervening years<sup>7</sup>
- the inclusion of an allowance for finance during construction within the distribution ODV Handbook<sup>8</sup>
- the inclusion of non-system fixed assets at their GAAP valuation<sup>9</sup>
- the pragmatic approach outlined in the paper regarding the carry-forward of apportioned regulatory asset base (RAB) values in the event of a merger or acquisition<sup>10</sup>
- the recognition within the paper that, in certain cases, the regulatory information sought may be based on principles other than GAAP – eg the use of ODV values and indexation.

### Issues with the roll-forward process

The roll-forward principle, including additions at “actual” cost, is, in theory, a pragmatic approach, eliminating the requirement for a full ODV revaluation annually, and the need to perform detailed annual analyses which compare “actual” values to ODV values.

For many line businesses, we predict that at least 80% – 90% of the value of the network at the end of the five year valuation period will be for assets which were on hand at the start of the period. Accordingly, any required detailed analysis of additions and the detailed analysis of depreciation on those additions is only analysing relatively insignificant and immaterial incremental values.

#### A. Depreciation (paragraphs 87 – 94)

The detailed requirement outlined in the above paragraphs is for ELBs to calculate depreciation *“using assumptions that are consistent with those used in the most recent ODV valuation”* (para 87). The footnote to para 87 states *“...the total economic lives of a particular asset class must be as prescribed in the ODV Handbook and the asset ages used must be derived from the same asset ages that were used in the most recent ODV valuation”*. This is further developed in para 92.

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<sup>3</sup> Decision paper – para 25

<sup>4</sup> Decision paper – para 26

<sup>5</sup> Decision paper – para 27

<sup>6</sup> Orion New Zealand Limited – *Submission on the Commerce Commission’s Valuation of the Regulatory Asset Base Decision Paper*, 17 November 2005, and a paper provided by NERA – *Review of the Information Disclosure Regime/Implementing Valuation Choice for System Fixed Assets*, 22 April 2005.

<sup>7</sup> Decision paper – para 28

<sup>8</sup> Decision paper – para 31

<sup>9</sup> Decision paper – para 29

<sup>10</sup> The paper – para 33

Different ELBs will take different approaches to their analysis and recording of assets for accounting purposes. For example, all overhead line assets might be given one depreciation rate by the ELB rather than the variety of different rates outlined in the Handbook. To comply with the papers' proposal, ELBs will have to split all additions into the relevant ODV depreciation categories, in essence requiring two sets of records, and to then roll this calculation forward.

We do not believe that the extra work and cost associated with the re-analysis of annual additions results in a depreciation calculation which is superior to that provided simply by taking a weighted average approach across a broader class of assets – eg all lines depreciated based on a weighted average life of 45 years.

The Commission could either issue a standard life for each broad grouping, (such as lines, cables, transformers etc) or permit ELBs to determine a weighted average for the whole network based on the latest audited ODV.

We **recommend** that the Commission reconsider or consult further on this matter, as we believe that the costs significantly outweigh the benefits of a marginally more accurate depreciation calculation and assessed RAB.

Even in years four and five of the cycle, the depreciation due to “new” additions since the last ODV will be minimal compared to that which is attributable to assets which were on hand at the date of the last full ODV.

We also note that at paragraph 91 the paper states *“because system fixed asset depreciation is on a straight-line basis, this component of depreciation will not change in the years between ODV revaluations.”* This statement is not correct, as certain assets will reach the end of their depreciable lives during the period. Accordingly, we would expect that depreciation expense on the assets revalued will reduce each year during the period, although this end-of-life reduction will be partially offset by the increase in depreciation arising from the CPI impact. The derivation of depreciation on the assets included in the last revaluation, and its inclusion as a separate line item, will be a difficult calculation for very little benefit.

Due to the difficulties with deriving and disclosing apportioned depreciation, for little benefit, we **recommend** that the proposed breakdown of depreciation by asset classes and asset life characteristics (ie, new or previously-revalued) be reviewed and the required detailed disclosure either eliminated or reduced.

## **B. Vested assets (paragraphs 76 – 78)**

We note that as ELBs adopt International Financial Reporting Standards (IFRS) some changes will result in the recognition and valuation of “vested”, “donated” and “subsidised” assets. We summarise these differences in the following paragraphs.

Firstly, the identity of the party making the capital contribution will have an impact. Where the “donor” or “contributor” is a local authority or government agency, our understanding is that such grants are to be offset from the value of the asset (ie it is held at a “net” value) with the value of the “donator” picked up in a subsequent revaluation.

Secondly, where the ELB builds the asset and a third party contributes towards the asset, if the third party is not a local authority or government agency, the asset is stated at its gross value and the contribution taken to income. However, under the standard, the income may be deferred over the life of the asset.

Thirdly, where the customer builds the asset (eg a new connection or subdivision) and the ELB buys the asset for less than the estimated cost to the customer, then under IFRS no “donation” is recognised. The difference will be picked up in the subsequent revaluation.

Under existing NZ GAAP, we currently recognise all of the above “vestings”, “donations” and “subsidies” as income in the year of the transaction.

Accordingly, in moving the roll-forward proposal ahead, it will be necessary to clearly define the required regulatory treatment for all of these situations, with respect to:

- asset values and their resulting depreciation impact, and
- the recognition of income associated with these assets. This also has a clear implication for the reporting of regulatory ROIs.

We **recommend** the Commission requires that for regulatory reporting purposes all forms of vested assets, donated assets, and subsidised assets, regardless of the donor, are valued at their ODV and are included in income in the year in which the asset is recognised.

### C. Asset classes (paragraphs 96-99)

We have noted above in our comments regarding depreciation that different ELBs will take different approaches to their analysis and recording of assets for accounting purposes. For example, within our financial accounting records we do not apportion capital expenditure on lines or cables into the different physical classes noted in figure 4, namely sub-transmission, distribution and LV. The proposal for an annual roll-forward at this level would require some detailed re-analysis and reapportionment of financial information on a project by project basis. Some contracts let to contractors would also comprise a “mix” of these classes, and will also require an estimated engineering reapportionment. The reapportionment requires a significant increase in work and complexity at the end of each project.

Paragraph 57 of the paper states that “...the Commission will require ELB’s to undertake a once-off roll-forward of their 31 March ODV 2004 valuations to a 31 March 2005 valuation, based on the roll-forward process and associated reporting requirements derived from this paper.” It will a very difficult and expensive task to retrospectively reapportion and reanalyse project data for what is now more than a two-year period – ie, any projects completed since the 31 March 2004 valuation.

We also noted above that the level of materiality is of concern. We do not believe that the extra work and cost associated with the re-analysis of annual additions produces a benefit which outweighs the additional costs. Ignoring large scale acquisitions (which are dealt with separately in the paper) the additions over a five-year period are also minor compared to the assets existing at revaluation dates.

We **recommend** that the Commission reduce the number of asset classes outlined in figure 4 in paragraph 98 of the paper to:

- lines
- cables
- substations and switchgear
- transformers, and
- other system fixed assets.

#### **D. Works under construction vs finance during construction (paragraphs 137-160)**

We are pleased that the Commission has recognised the financing costs associated with construction of system fixed assets. This is consistent with the costs which an averagely-efficient new entrant would incur. A specific cost of financing component will be a useful addition to the values included in the ODV Handbook.

We note that in paragraph 158 the paper proposes to use the 7.35% WACC recommended by Dr Lally<sup>11</sup>. We note that, as yet, we have seen no final decision from the Commission as to a point estimate for WACC. We also note that a number of submissions from ELBs support a WACC above this point estimate. We consider that it is inappropriate to lock in this value for the period to 2008.

We have not been able to undertake a more detailed review of the proposed treatment, including a review of the weighted average length of time our jobs are open, due to the very tight timetable required by the Commission for this submission.

#### **E. Choice to undertake a full ODV in interim periods**

While we commend the paper's intention to not require an annual ODV and to minimise the complexity of the annual update process, we believe that under some circumstances an ELB may choose to undertake a full revaluation either annually, or within the revaluation cycle. We believe that an ELB should not be precluded from doing so, and in determining ODV should use CPI to adjust the replacement costs identified in the latest version of the ODV Handbook. We **recommend** that the Commission allow ELBs to undertake a full revaluation outside of the usual five-year revaluation cycle.

#### **F. Easements (Decision paper, paragraphs 146)**

We have submitted extensively that easements should be included within the RAB. The decision paper (paragraph 146) states *"... the Commission confirms its decision not to allow the inclusion of intangibles nor to allow the inclusion of easements at replacement cost. The Commission has already decided that easements are to be included in the valuation at their historical acquisition cost."*

Easements are an essential element of the operation of an ELB, equivalent to the ownership of land. ELBs require easements in order to be able to supply customers and access and repair assets. The considerable investment ELBs have made in acquiring easements over extended time periods is an asset which should be reflected in our RAB.

In our submissions we have consistently supported the ODV approach on the basis that the approach models the entry costs which would be incurred by an averagely-efficient new entrant to replicate an existing network. Easements are costs which the new entrant would have to incur. Allowing ELBs to only use historical cost values is equivalent to allowing us to use historical cost for construction costs, or not allowing ELBs to revalue land assets.

We ask that the Commission reconsider this inconsistent decision.

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<sup>11</sup> M Lally: The Weighted Average Cost of Capital for ELBs, 8 September 2005

## Conclusion

We are concerned that the approach taken in the paper requires a detailed re-analysis of each job/project undertaken in order to provide the required categorisation. We see this as being an expensive and impractical requirement which provides very little additional benefit due to the incremental nature of the analysis.

We **recommend** that the Commission reduces the level of complexity associated with the analysis of additions and the determination of depreciation. We have made some practical recommendations which we believe will assist in achieving the outcomes which the Commission requires, but at the same time do not impose significant additional costs upon ELBs.

We thank the Commission for the opportunity to submit on the roll-forward process, and will be happy to take part in further consultation.

If you have any questions, please contact me ([graeme.wilson@oriongroup.co.nz](mailto:graeme.wilson@oriongroup.co.nz)) or DDI (03) 363 9653

Yours faithfully



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