

**By email** electricity@comcom.govt.nz

7 March 2008

Information Disclosure Review  
Network Performance Branch  
Commerce Commission  
P O Box 2351  
Wellington

**Orion New Zealand Limited submission on the draft Electricity Information Disclosure Amendment Requirements issued 20 December 2007**

- 1 Thank you for the opportunity to comment on the draft amendments to the Requirements (the proposal).
- 2 We emphasise that our submission has been prepared without a clear understanding of the regulatory regime within which the information disclosed ultimately will be employed. As noted in our recent submission in relation to the concurrent reset of the price and quality thresholds<sup>1</sup>, the future regulatory framework for electricity distribution businesses (EDBs) remains uncertain. Many critical aspects of the ongoing operation of the thresholds framework are not analysed or discussed in any acceptable level of detail by the Commission in its Discussion Document. In parallel, wide-ranging proposed changes to Parts 4 and 4A of the Commerce Act (the Act) continue to be developed, which are likely to significantly alter the regime under which EDBs are regulated.<sup>2</sup>

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1 Orion submission, 18 February 2008.

2 Most notably, the existing price thresholds will become a legally binding default price path, ie, a form of control. Under the proposed new regime the Commission will have a range of powers where there is a breach of the default price path, including the power (a) to require compliance with the default price path (b) to seek penalties and remedies. This is unlike the present threshold regime where a parallel enforceable controlled price does not emerge until such time as the Commission adjudicates upon an authorised price.

- 3 These uncertainties surrounding the ongoing status of the thresholds regime limit the extent to which we can provide meaningful commentary on the relative merits of the proposed revisions to the *disclosure* regime. The consequences of those revisions simply cannot be foreseen at this time. The role of regulatory asset values in the regulatory price setting process is apposite. The consultation package on the revised disclosure Requirements proposes an indexed historical cost (IHC) approach for rolling forward asset valuations. However, in the absence of a comprehensive understanding of the way such an approach would impact upon the *thresholds* framework, and ultimately upon *regulated prices*, it is difficult for us to provide our support. Indeed, the determination of regulatory asset values for pricing purposes has *not* played a significant role in the thresholds regime to date.<sup>3</sup> If regulatory asset values *were* to play a central role in determining prices then several critical considerations would need to be addressed before EDBs were in a position to reach an informed view on the appropriate valuation methodology, including:
- 3.1 the manner in which opening asset values would be established for the purposes of establishing initial prices; and
  - 3.2 the way in which changes to asset values over time will be treated by the regulatory framework.
- 4 The uncertainties surrounding the determination of the regulatory asset base and its role in the price setting process in turn affect what can usefully be said about other key proposals, and vice versa. For example, the Commission has indicated a preference for a 'tax payable' basis for regulatory tax allowances. However, a key issue is how the tax book value relates to the regulatory asset base, which is not clear. In a similar fashion, the risks associated with different valuation methodologies affect the weighted average cost of capital. In the absence of further details on fundamental issues relating to the thresholds regime, including the way in which that regime may change as a result of the ongoing review into Part 4 and 4A, it is not possible to gauge a clear understanding of how the information disclosed will be used.
- 5 It is largely because of these interdependencies that we have proposed to MED that the current threshold regime be continued until the revised regulatory framework is in place, including finalised input methodologies.<sup>4</sup> Consequently, although this submission can and does provide an indication of the *more detailed*

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3 Although an ODV valuation has been used for some aspects of the information disclosure regime, its only application within the thresholds regime has been as an input into Meyrick's productivity and profitability analysis.

4 See: NERA and Mark Berry, *Response to MED Discussion Document: Review of Regulatory Control Provisions under the Commerce Act 1986: A report for Orion New Zealand Limited*, 6 July 2007, available at [www.oriongroup.co.nz](http://www.oriongroup.co.nz).

implications of the proposed revisions to our internal financial systems, we cannot provide unqualified support in the absence of a thorough understanding of the wider implications. Subject to this important qualification, we broadly agree with several of aspects of the proposals namely:

- 5.1 that the choice of disclosure and valuation methodologies should be guided by economic principles. As we have emphasised on past occasions, we believe that the purpose of economic regulation should be to replicate to the greatest extent possible the outcome of competitive markets in circumstances where the prospect of competition is limited. We note that this philosophy is consistent with the views of the government, which believes that:<sup>5</sup>

*'the focus of economic regulation should be cooperative, forward-looking and incentive-based, where the regulator and businesses work collaboratively to seek to mimic the outcomes of competitive markets.'*

- 5.2 that indexation by CPI should occur in the periods between formal ODV valuations.

As noted above, the Handbook replacement costs become rapidly outdated in the period between valuations. CPI indexation permits some recognition of this increase throughout the period and avoids revaluation "spikes".

We have previously submitted in support of CPI indexation, most recently in our submission dated 8 May 2006 on the Commerce Commission's paper "Methodology for Rolling Forward the Regulatory Asset Base for System Fixed Assets". We have also submitted that an EDB should be able to undertake a full ODV on a more regular cycle than the five year period indicated.

We agree with the change to a five-yearly publication of ODV reports, but only if there is a satisfactory implementation of an inter-valuation update process. We also agree with the ODV date of 31 March of the year concerned.

Further, we submit that an interim ODV can be achieved by indexing replacement costs rather than indexing the valuation as a whole.

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5 Key Note speech by Commerce Minister Lianne Dalziel to the 8th Annual Competition Law & Regulation Review, 18 February 2008.

However, we would welcome the opportunity to explore the merits of alternative valuation methodologies once the revised regulatory framework is in place, and the Commission has finalised a comprehensive set of input methodologies.

- 5.3 the movement away from strict compliance with GAAP compliant financial statements to a set of prescribed disclosures which are based on, but may depart from, GAAP.

We have previously submitted in support of this approach, most recently in our submission dated 17 November 2005 on the Commerce Commission's "Valuation of the Regulatory Asset Base Decision Paper".

- 5.4 the removal of deferred tax from regulatory information disclosures.

We have submitted previously that although deferred tax is an accounting requirement, it is non-cash and most unlikely to ever arise as a liability settled in cash – and consequently that deferred tax expenditure/benefit and deferred tax assets/liabilities should also be removed from the disclosures and in the calculation of the regulatory return.

- 5.5 the treatment of capital contributions and vested assets as income in the year of receipt.

We note that a current draft interpretation (D24) issued by the International Financial Reporting Interpretations Committee (IFRIC) in January 2008 may require a different accounting treatment for capital contributions than is presently allowed under the NZ IFRS.

There may be differences between the accounting and regulatory treatments of items of income and expenditure, and although this variance is acceptable where differences are clear and easy to identify, major or complex variations would cause EDBs extreme difficulty in keeping the "two sets of books" required.

- 6 Having identified our broad areas of agreement with a number of the details of the proposals above, there are several areas where we have concerns about the proposals.
- 7 In particular, we submit that there is insufficient clarity regarding the ongoing regulatory framework to contemplate a departure from ODV as the base for regulatory disclosure purposes at this time. We have submitted regularly over the years in support of ODV as our preferred valuation methodology, since it models

the notional averagely-efficient new entrant in a competitive market. We submitted in support of ODV in our submission dated 17 November 2005 on the Commerce Commission's "Valuation of the Regulatory Asset Base Decision Paper".

- 8 We note that the existing ODV Handbook is significantly out of date and markedly understates our actual replacement costs and accordingly an ODV based on the current Handbook is significantly understated.
- 9 Further, we have concerns in particular with the impracticality or impossibility of preparing disclosures retrospectively to the 1 April 2004 starting point. We also have concerns regarding the excessive level of detail required – for example, the extent of the disclosures required within reports MP1 and AV1.

#### **Specific comments on the proposed disclosures, definitions and Handbook**

- 10 We note that PricewaterhouseCoopers (PwC) has undertaken an extensive review of the proposed information disclosure reports, definitions and Handbook for a group of EDBs. **As a general rule, and also subject to the important qualifications noted above, we endorse and support the comments raised by PwC in the appendices to their submission.** In the following paragraphs, also subject to the important qualifications noted above, we note any points of difference we have with PwC's appendices and we also expand on matters discussed by PwC in those appendices.

#### **Financial statement disclosures**

- 11 We support the proposal to no longer publish all the disclosures in the NZ Gazette. However, we believe that publishing even a reference in the Gazette is unnecessary. Our experience is that parties seeking disclosed information review EDB websites to access the data, and few people other than regulators, consultants and the EDBs themselves review the data.
- 12 We believe that publication on EDB websites is all that is required.
- 13 We note that PwC has suggested a process to enable continued information disclosure for the 2007/8 financial year, while at the same time avoiding the considerable difficulties which retrospective analysis poses for the industry.

- 14 We submit that an alternative worthy of consideration is that:
- 14.1 all EDBs undertake a new ODV, based on an updated ODV Handbook, as at either 31 March 2008 or 31 March 2009.
  - 14.2 the revised information disclosure Requirements apply from the start of the 2008/09 year – i.e. from 1 April 2008 – at the earliest.
  - 14.3 the 2008 disclosures are prepared on the basis of New Zealand GAAP as it existed prior to the adoption of NZ IFRS. In our experience, it was not a major task to restate our 2007 NZ IFRS financial statements in a form consistent with “old” NZ GAAP.
- 15 The advantages of this approach are:
- 15.1 EDBs start the new regime with a RAB which reflects current replacement costs and current asset values.
  - 15.2 the problems associated with retrospective analysis back to 1 April 2004 are avoided.
  - 15.3 EDBs can set up processes and systems from 1 April 2008 to capture the particular information which the proposals seek to capture.
- 16 In order to achieve this, the existing Requirements would need to be altered to allow “old” GAAP to be utilised and auditor statements revised to ensure compliance with the Commission’s Requirements rather than current NZ GAAP.
- 17 We believe that the approach provides for consistency and continuity in data disclosures, whilst avoiding considerable rework.

## **Report FS1**

- 18 We submit that vested assets and cash capital contributions should be recognised as revenue in the year of vesting, rather than spread as income over the life of the asset – regardless of the accounting treatment under NZ GAAP.
- 19 We note that there are other differences between accounting and regulatory treatments, and so the categorisation required would be extremely difficult to derive retrospectively. This is particularly the case where refurbishment and renewal expenditure may be being treated somewhat differently for accounting purposes than the ODV model suggests; e.g. a major reconductoring expenditure may be capitalised for accounting purposes, but not result in an increase in ODV as the underlying pole age has not been changed.

- 20 We would need time to develop systems which record projects undertaken on the basis of the proposed split, so unless a substantial review of prior year jobs is undertaken it would not be possible to comply retrospectively.

## Report FS2

- 21 We primarily analyse our assets by their “type” – lines, transformers, switchgear, cables, etc.
- 22 Although we budget our capital expenditure broadly into “causes” – in our case, consumer connections, network extensions, reinforcement, underground conversions, replacement or major projects – these categories do not easily transfer into the categories in the proposal.
- 23 Secondly, the purchase of an item of equipment (eg a transformer or piece of switchgear) is often undertaken without a clear linkage to one of the “causes”. A new transformer might initially be used to replace one which has become overloaded, but could subsequently be used in a new subdivision or replace one which has failed. We move transformers and certain types of switchgear within our network throughout their lives.
- 24 As noted above, we budget our capital expenditure into a number of categories and we broadly report annual capital expenditure against the categories. However, report FS2 requires that we effectively categorise assets *commissioned* into the required categories.
- 25 Although the determination of the gross value of assets commissioned is straightforward (cash capex plus/minus the movement in capital work in progress) it is not straightforward for us to apportion assets in the categories proposed and then to identify commissioned work.
- 26 We also note that the proposed apportionment is arbitrary, as some jobs have elements of more than one category and we would need to analyse each job at completion to determine the primary “cause” or to apportion the “cause” across two or more categories.
- 27 Overall, without adequate justification by the Commission of how this extra information will be used we can see no compelling argument to retain this in the proposals.

**Report FS3**

- 28 We have previously submitted that the appropriate base for tax depreciation should be the *regulatory* depreciation, as regulatory depreciation should mirror the depreciation charge of relevance to an averagely-efficient new entrant – assuming that Handbook (Regulatory) replacement costs are reasonable.
- 29 Any other approach treats an EDB differently on the basis of whether it has held the regulated assets for a long period of time, or recently acquired those assets. All other things being equal, an EDB which has held the assets for a long period will have *lower* tax depreciation, and therefore higher tax expense, and therefore a lower net profit and return, than an EDB who recently acquired the assets for a multiple of ODV. Conversely, an EDB which recently acquired the assets for a multiple of their ODV will have a large tax depreciation expense, and therefore lower tax expense, and therefore a higher surplus on the *same* assets.
- 30 If we wish to compare one ‘notional’ EDB with another, then calculating tax on a consistent basis is important – the ownership history of the assets should not have an impact. This would be distortionary, and the notional tax calculation should correct for this by replacing tax depreciation with the ‘regulatory’ depreciation.
- 31 Further, we note that the “accounting depreciation” term in FS3 should be “Regulatory depreciation”, and agree with the depreciation expense disclosed in FS1.
- 32 We also believe that the interest tax shield should be removed from the calculation as EBIT is used in calculating income tax, and deductible interest should be removed from the schedule as well.

**Report AV2**

- 33 It is not possible for us to provide a breakdown of asset value by asset class unless each individual asset is actually assigned to an asset class. The roll-forward approach does not provide asset classes for asset additions, which are brought in at cost. Additions would normally be project based (with each project including assets from a number of classes). A manual estimation at project end would be required.

**Report MP2**

- 34 We would struggle to provide this information retrospectively. Given time to develop systems to record costs to meet the definition in the proposals some of the measures could be determined, but we question the usefulness of the measures. Further, we seek to clarify whether capital expenditure includes donated and/or subsidised assets, and whether the comparator intends to measure commissioned works or actual capital expenditure.
- 35 The proposed ROI calculation is outlined in paragraph 421 of the companion paper. In addition to the various points raised elsewhere in our submission and in the PwC submission, we submit that an adjustment (write-down) should be allowed for assets acquired at above their regulatory value.
- 36 Secondly, we believe that the numerator should not be adjusted for the impact of an interest tax shield as the regulatory profit in report FS1 should be prepared on an EBIAT basis.
- 37 We also note that the approach taken in the denominator of the proposed ROI excludes the annual depreciation expense, which we believe should be deducted. Further, in a year in which a revaluation takes place, the proposed formula excludes the revaluation from the denominator. We contend that a much simpler approach – (opening plus closing regulatory asset base) divided by two – provides a much more logical and defensible denominator.
- 38 We support the exclusion of changes in asset register information – i.e. “lost” and “found” assets from the regulatory profit, and therefore from the ROI.

**Report MP3**

- 39 Along with other EDBs, we operate a charging basis which uses grid exit metering information. It is not possible for us to provide the information proposed by customer class. Many other EDBs have customer categories which differ from the cases defined in this table, and those EDBs would also be unable to fulfil this requirement. We recommend allowing EDBs to adopt the categories in their pricing for the purpose of disclosing this information, which may be by consumer market segment, load group category or connection category.

## **Report AM1**

- 40 Although we support the publication of asset management plans before the commencement of the financial year, we believe that a more appropriate publication date should be 28 February or 31 March. This would work in much better with EDB budgeting and business planning cycles and allow additional months of “better” information to be included. The closer the forecast can be to the start of the year, the smaller the variances between actual and planned expenditure.
- 41 It is also unclear whether the intention of AM1 is to report only actual “cash” expenditure; whether it is intended to include the value of vested assets; or whether it is intended to include only the works actually commissioned during the year.
- 42 If the same principles are to be used in report AM1 as are proposed for use in FS1 – ie, accounting and regulatory capital expenditure and maintenance expenditure definitions may not be consistent – we believe that an enormous amount of time would be spent reconciling and apportioning these estimations.

## **Valuation methodology**

- 43 We support PwC’s comments in relation to references to ODV principles in the proposals (Appendix D).
- 44 PwC’s extensive list illustrates how the Commission’s proposals are heavily reliant on information that is derived from a unitised valuation method (such as ODV), where assets are broken down into relatively homogeneous parts for valuation.
- 45 Our cost reflective pricing methodology and process of allocating costs to connection categories, which depend on their use of various assets (as required by the disclosure Requirements), also relies heavily on the information derived from our ODV valuation – we believe that our costing and pricing methodologies are efficient relative to other methodologies
- 46 Of particular note, an IHC valuation method, by contrast, neither supports our detailed asset breakdowns required to value removals of asset components, nor provides a basis for valuing different categories of assets (as single projects often span many asset categories).
- 47 The extensive references to ODV cannot simply be updated to an alternative valuation method if that alternative method does not provide the necessary detail. If the Commission chooses to move away from an ODV type valuation, we

believe that it must also accept and apply a reduced information disclosure regime.

- 48 We are also concerned that a consequence of moving to IHC is that ex-ante reviews of the prudence of investments may be required since the methodology lacks the post-investment optimisation process provided by the ODV methodology. Likewise, the Commission does not indicate whether an IHC methodology might also entail an ex-post assessment of the prudence of investments. The uncertainty surrounding the scope and form of potential prudence assessments under an IHC methodology is likely to reduce confidence to invest, to the detriment of the long term interests of consumers. Moreover, if any such review processes were poorly designed or administered this would also have the likely effect of delaying investment and adding significantly to regulatory compliance costs.

### **Concluding remarks**

- 49 Thank you for the opportunity to make this submission. If you have any questions, please contact Rob Jamieson, email [rob.jamieson@oriongroup.co.nz](mailto:rob.jamieson@oriongroup.co.nz). If the opportunity is available, we are willing to present in support of this submission.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Rob Jamieson', with a stylized flourish at the end.

Rob Jamieson  
**General Manager - Commercial**