ELECTRICITY DISTRIBUTION: VALUATION OF EASEMENTS

Ergon Energy's Response to QCA's Discussion Paper

May 2003

1. BACKGROUND

In April 2003, the Queensland Competition Authority issued its Discussion Paper, *"Electricity Distribution: Valuation of Easements"*. The Discussion Paper invited submissions from interested parties. Ergon Energy Corporation Limited, (Ergon Energy), as one of the two electricity distributors in Queensland offers the following submission.

Ergon Energy is grateful to the Authority for this opportunity and makes this submission publicly available.

It may be important to place the easement valuation in its proper context. Easements form part of the Regulated Asset Base, which is to be revalued by the Authority in its Regulatory Review, effective from 1 July 2005. In its May 2001 Final Determination, "Regulation of Electricity Distribution" the Authority stated

"The Authority has adopted a DORC method for general asset valuation purposes"

and, in relation to easements

"Easements have been valued at historic cost for the purpose of the current regulatory review. However the Authority will undertake further work to identify the most appropriate long term approach to the valuation of easements, including the issue of CPI adjustment."

The QCA Discussion Paper signals the 'further work' required to establish the long-term approach. In signalling the further work the QCA refers to the various views held in different jurisdictions as well as some issues that relate to particular situations.

2. OVERALL STRUCTURE OF DISCUSSION PAPER

The Discussion Paper seeks comments on only one issue (*which asset valuation method should apply to determine the valuation of easement assets*). The Discussion Paper, however, provides useful background information on the characteristics of easements, various valuation methods applied as well as the experience in other jurisdictions.

In the response that follows Ergon Energy will not only provide its suggested valuation method, but we will also offer comments on some the matters that are seen to be difficulties in this subject. It is our contention that some of the issues, difficulties and limitations do not stand up to close scrutiny.

Our submission will follow the sequence of the Discussion Paper, but we will commence with some general comments.

3. THE ECONOMIC FUNDAMENTALS OF AN ASSET VALUATION

It is considered that in analysing the subject, and in particular the Discussion Paper, one needs to make sure that there is no confusion between two very separate issues

- The underlying economic fundamentals that lie behind all asset valuation methodologies.
- The practical difficulties, and in some cases, because of this, alternate valuation methods that are used, and their justification.

Ergon Energy believes the distinction is important because matters of principle are well founded and stand for a period of time while local circumstances can, sometimes with good justification, drive a practice that departs from the basic principle. Such a departure does not set aside the principle, but simply provides the basis for what can be seen as a temporary departure.

Ergon Energy considers that some of the practices followed in other jurisdictions ought to be seen as temporary departures for local pragmatic reasons rather than indicators that a matter of principle is at stake. In several cases, decisions to depart from the DORC valuation method have been taken in order to avoid revenue and price shocks. In fact both the IPART's 1999 Determination[1] as well the ACCC 's 2000 NSW and ACT Transmission Determination[2] use 'price shocks' as at least one of the grounds for this action. The QCA's May 2001 Final Determination[3] carried out a comprehensive review of the impact on the asset value and prices before concluding not to apply the DORC valuation.

Such an approach implies that the DORC valuation would have been applied had the valuation not indicated a price shock. In the QCA case, the Authority both took a decision to limit the valuation of the assets by rejecting the DORC valuation of easements AND subsequently chose to smooth the final Revenue Cap (already affected in part by the valuation decision) AS WELL AS side constrain the prices to limit price shocks.

Ergon Energy believes that such an approach is flawed, for it limits the ability of the Authority to see the 'true' position before taking any decision to smooth the outcome on the grounds of a price shock.

In summary Ergon Energy agrees with the general position summarised by the QCA in its May 2001 Determination

"The overwhelming support for the DORC approach by stakeholders and regulators in other jurisdictions is consistent with QCA's analysis. The primary rationale for using DORC to value assets, in preference to other valuation systems, is based on the principle that it provides a better indication of the opportunity cost to the owner (and the economy) of the asset devoted to the particular activity."[4]

Ergon Energy believes this is particularly true in the case of monopoly assets, where, because of the monopoly nature of the asset, an approach to asset valuation based on the 'value to the customer' cannot be used.

In the remaining discussion Ergon Energy will address the particular comments in the Discussion Paper. As mentioned earlier an attempt will be made to separate those matters of valuation principle from particular practical issues. This may help in establishing whether some arguments in the Discussion Paper are evidence that valuation of easements are a special case or not.

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[1] IPART 1999 Regulation of New South Wales Electricity Distribution Networks – Determination and Rules under the National Electricity Code

[2] ACCC 1999 "NSW and ACT Transmission Network Revenues"

[3] QCA 2001 "Regulation of Electricity Distribution Final Determination"

[4] QCA 2001 "Regulation of Electricity Distribution Final Determination" Section 5.3 p58

4. CHARACTERISTICS OF EASEMENTS

The Discussion Paper mentions the unique nature of easement assets driving the differing treatment by regulators. Ergon Energy questions whether in fact these features are 'unique' and therefore are sound reasons for departing from the basic principle of DORC espoused by the QCA. Ergon Energy would like respond to the QCA's dot points under this heading in the Discussion Paper.

- *The QCA argues that a registered easement is a 'right' and does not involve ownership of the land over which the line passes.* While this is true, there are assets of a similar type (licences) that exhibit similar non-tangible characteristics that are nevertheless able to be valued using the DORC methodology.
- *The QCA points out that easements are granted in perpetuity, are not replaced, and do not have depreciation.* Again this is a true statement, but it is no different for land, to which regulators (perhaps with one exception that will be addressed later) have no issue in applying a DORC valuation methodology. It is true that perpetuity means that there will be no depreciation, which of course only means that at any point in time the DORC and the ORC are the same. However the absence of depreciation simply makes the two step valuation process (valuation of ORC and then adjustment to DORC) a one step process. Obviously the absence of depreciation means that there will be no allowance for recovery of the depreciation, or return OF asset, within the revenue cap.
- *The QCA states that there are minimal administration costs associated with easements.* Whether or not this is true, the comment is surely a non sequitur. The operating costs of an asset are surely irrelevant to any valuation issue.
- *The QCA states that there is no open market on easements, and if a line were to be removed the value of the easement may not be recoverable by the DNSP*. The absence of an 'open market' on easements does not deny the differential in value to a land-owner in having any encumbrance removed. In other words Ergon Energy believes the value of an easement at any time can be measured by the difference between the market value of land encumbered by an easement and the market value of unencumbered land.

5. OPTIONS FOR THE VALUATION OF EASEMENTS

Ergon Energy agrees with the Authority that the four methods outlined and then discussed in some detail represent the approaches or suggested approaches in much of the discussions on this topic.

However, Ergon Energy believes in the primacy of the DORC valuation method favoured by all regulators as indicated above. Nevertheless, Ergon Energy considers that despite this primacy of the DORC principle, there may be an occasion when:

- the DORC method provides an incorrect answer. This is able to be demonstrated in one case involving land values. In the Sydney Airport case there was a situation where 'reinforcing feedback' or 'bootstrap accounting' applied[5]. In that instance the existing airport actually impacts on the land value. Were the airport not there the land value would be considerably less. This would be an instance where an alternate method should be considered.

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[5] Ergas, H. & Smart M 2000 "Land & Easement Valuation in Pricing for Networked Businesses – A Critical Appraisal" Network Economics Consulting Group. The terms relate to the circumstance where the existence of the infrastructure facility profoundly affects the surrounding property values. Caution is required to ensure that one does not infer a market value based on surrounding land, that is in turn based on the airport's proximity.

The instances of reinforcing feedback are not common, but typically only apply in transport infrastructure and not 'pipes and wires' businesses.[6]

- owing to practical difficulties in obtaining relevant data, it may be necessary to use a 'second order' valuation method. This could happen if the distributor were not able to provide sufficient information to use the DORC methodology. Importantly as stressed earlier, that ought not to be regarded as departure from the DORC principle but rather an acceptance that such a method is not practical in the circumstances.

It is important to reiterate that Ergon Energy does not believe that a potential price shock is a valid ground for a departure from the DORC valuation. While it is always within the power of the regulator to make determinations based on the price impact on the market, Ergon Energy believes an *ex ante* decision to reduce the valuation puts at risk the regulator's ability to appreciate the correct starting point before making any smoothing or side constraining decisions.

6. REQUEST FOR COMMENTS

To summarise, Ergon Energy believes that the DORC valuation method provides the gold standard in all asset valuation, including easements. This view is widely held by Australian regulators as well as distributors as it provides the opportunity cost to both the owner and the economy.

While there may be circumstances where this method can be departed from they are quite limited, relating to

- a particular problem ('reinforcing feedback') that sometimes occurs in transport based infrastructure, in which case its presence is discernible.
- a difficulty in the provision of data necessary to facilitate a DORC valuation, in which case it may be necessary to use indexed historical cost as it provides the nearest alternative.

Ergon Energy believes that an *ex ante* judgement about the potential for a price shock is a flawed analytical approach which limits the regulator in having the full facts before making a decision about smoothing or side constraining.

7. BIBLIOGRAPHY

AASB 1999 "AASB 1041 – Revaluation of Non- Current Assets" 1999

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QCA 1999 "Electricity Distribution: Asset Valuation, Depreciation and Rate of Return, Discussion Paper"

QCA 2001 "Regulation of Electricity Distribution Final Determination"

QCA 2003 "Electricity Distribution: Valuation of Easements"

Small, J 2000 "The Valuation of Regulated Assets" Network Economics Consulting Group

Zauner, R. 2000 "Valuation Principles and Tariff Setting Framework" Sinclair Knight Merz

[6] Ergas, H. & Smart M 2000 "Land & Easement Valuation in Pricing for Networked Businesses – A Critical Appraisal" Network Economics Consulting Group. The exclusion of 'pipes and wires' business is on the grounds that they mostly rely on easements rather than total dedication of large areas of land. The impact on land values is clearly much less.