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2004 REGULATORY RESET **ASSET VALUATION OFF-RAMP** **FINAL DECISION**

The Commission has made the following findings:

- A. that, during the 2004 Reset, the Power and Water Corporation (“Power and Water”) was unable to confirm the accuracy of its estimates of the depreciated optimised replacement cost (“DORC”) value of the regulated network assets that were in service on 1 July 1999 (or 1 July 2000) or the roll-forward in these values to 1 July 2002;
- B. that, on the basis of the conclusions of a desktop analysis subsequently undertaken by Power and Water, the DORC value used in the 2004 Reset for regulated network assets as at 1 July 2002 (of \$430.5 million excluding gifted assets) was misstated;
- C. that the desktop analysis itself resulted in flawed estimates of the DORC values of Power and Water’s regulated network assets as at 1 July 2002;
- D. that it could be at least another two years before Power and Water has undertaken both a physical stocktake of the assets concerned (in 2005-06) and a revaluation of those assets (in 2006-07), with such a process still unlikely to provide a valuation of Power and Water’s network assets as at 1 July 2002 suitable for regulatory purposes;
- E. that the value of Power and Water’s regulated network assets underlying the published and audited financial accounts (“book value”) at the end of the financial year preceding 1 July 2002 (of \$279.5 million excluding gifted assets) was significantly below any of Power and Water’s estimates of the DORC value of the regulated network assets as at 1 July 2002; and
- F. that, in the lead-up to and in the 2004 Reset Determination, the Commission erred by failing to approve a basis of the valuation for regulatory purposes, for use during the second or subsequent regulatory control periods, of regulated network assets generally in service on 1 July 1999 and those brought into service after 1 July 1999 (as required under clause 6(1) of Schedule 7 of the Code).

In view of these findings, and having regard to the factors specified in clause 6(2) of Schedule 7 of the Code that the regulator must consider when approving a basis for determining regulatory asset values, the Commission has decided:

- 1) that a ‘roll-forward’ methodology implemented in accordance with generally accepted regulatory practice (i.e., the approved valuation of assets in service at an initial point in time (the “initial regulatory asset value”) adjusted in full for subsequent asset acquisitions, asset disposals, annual depreciation and inflation) is the most appropriate basis for the valuation of network assets for regulatory purposes during the second *and* subsequent regulatory control periods pursuant to clause 6(1) of Schedule 7 of the Code – with the

Government also being called upon to initiate a Code change to reinforce the use of this methodology into the future;

- 2) that the initial regulatory asset value for use in the approved roll-forward methodology should be the value as at 1 July 2002, which is the date that Power and Water was corporatised;
- 3) for the purposes of establishing the initial regulatory asset value for use in conjunction with the roll-forward methodology:
 - a) sole reliance on the available DORC values may not be appropriate in the NT circumstances;
 - b) in such circumstances, the initial regulatory asset value must be determined in a manner that most effectively achieves the desired outcomes set out in clause 63 of the Code and has regard to the factors specified in clause 6(2) of Schedule 7 of the Code;
 - c) regulatory asset values so determined are unlikely to involve a single correct value, with a range of plausible values likely to result; and
 - d) where it falls on the Commission to determine this initial regulatory asset value, the Commission must make such a determination also having regard to the objectives stated in section 6(2) of the *Utilities Commission Act*;
- 4) that, in the NT context, the plausible range of regulatory asset values of Power and Water's network assets as at 1 July 2002 (i.e., the initial regulatory asset value) is:
 - a) at the lower bound, the book value of those assets; and
 - b) at the upper bound, the true DORC value of those assets;
- 5) that, within this plausible range of initial regulatory asset values, in the Commission's opinion the most appropriate single value taking into account the factors described in clause 6(2) of Schedule 7 of the Code, the desired outcomes set out in clause 63 of the Code and the objectives stated in section 6(2) of the *Utilities Commission Act* is **\$350 million** excluding gifted assets; and
- 6) that had this initial regulatory asset value been used for the purpose of the 2004 Reset Determination, the Z factor would have been calculated as **-7.4%** ("the corrected Z factor").

Given these findings and decisions, and pursuant to the 'Asset valuation off-ramp' provision of the Commission's 2004 Reset Determination, ***the Commission is therefore satisfied that errors in the regulatory asset values underlying the determined value of the Z factor in the 2004 Reset Determination resulted in an error in that factor equivalent to more than one year's allowed price increase under that determination.***

Accordingly, for the forthcoming year 2005-06, Power and Water must make the equivalent of a Z factor adjustment to the current year's [i.e., 2004-05] weighted average tariff when applying equation (3) in the 2004 Reset Determination for the purpose of proposing the network access tariffs to apply to its regulated networks on or after 1 July 2005, to be implemented as follows:

- 1) for the purposes of the weighted-average price index of network tariffs in 2004-05 to be used when calculating the approved index of tariffs in 2005-06 and subsequent years, the approved 2003-04 index be adjusted

by a corrected Z factor and then escalated by CPI-X (with the 2004-05 index calculated in the 2004 Reset being put aside); and

- II) to allow sufficient time for the subsequent consideration of Power and Water's network pricing principles and methods, the allowed S factors for application during the second regulatory control period be slipped by a year on those approved in the 2004 Reset Determination.

Alan Tregilgas
Utilities Commissioner
(for the Utilities Commission)
30 March 2005