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SUBMISSION ON PROPOSALS FOR PRICING METHODOLOGY REQUIREMENTS

- 1 This submission is provided in response to the Commerce Commission's (the *Commission*) Consultation Paper titled "*Revised Information Disclosure Requirements and New Section to the Information Disclosure Handbook on Pricing Methodology and Line Charges*" dated 15 June 2006.
- 2 We welcome this opportunity to comment on the Commission's proposals.
- 3 We understand that other distributors have different views on pricing and what is appropriate to disclose in terms of methodology, which we respect and largely support. However, we have written this submission on the basis that the Commission considers that the "building block" approach is required.
- 4 We have written this submission, as with all our submissions, on the principled basis of consistent application of the "averagely efficient new entrant" test. In particular, returns should not be capped at WACC because WACC represents the return achieved by the averagely efficient new entrant and individual companies will achieve returns above or below WACC, depending on their efficiency. It is this ability/potential to earn above WACC returns that provides distributors with the incentive to invest for the long-term benefit of consumers, consistent with any new entrant in a competitive market. Hence:
 - ODV must be established using realistic parameters, particularly unit replacement costs that are not at the efficiency frontier as this is not what happens in a competitive market, on average.
 - Returns do not have to be capped at an industry average WACC. In particular, they may be above this for distributors that are more efficient

than the averagely efficient new entrant. This applies to both the overall return and also to the returns from the various groups that distributors use for their pricing.

- The Commission's estimate of WACC also needs to be realistic, as we have explained in our previous submissions to the Commission on WACC.

Terminology

Prices and charges

- 5 There are many inconsistencies in the use of the words "*price*" and "*charge*" in the proposed documentation. While these words commonly tend to be used interchangeably, we submit that they have different meanings and consistency in their use would clarify understanding.
- 6 In our view, a charge results from multiplying a price by a chargeable quantity. That is, **charge = price x quantity**. A pricing methodology or derivation results in a set of prices, not charges. In general, we consider the Commission's terminology to be appropriate for the pricing methodology requirements themselves and for the price threshold legislation, but inappropriate for the requirements to publish line "*charges*", when the Commission means "*prices*".

Consumer and connection

- 7 In general, distributors (ie ELBs excluding Transpower) provide delivery services to connections, rather than consumers (ie end-users). Consequently, prices generally apply to load groups at connections, which generally coincide with consumer's installation control points (ICPs). There are exceptions where:
- prices apply by market segment if the distributor contracts directly with consumers, or
 - prices apply by connection category if the distributor charges for its service on the basis of quantities measured at the grid exit point (GXP).
- 8 We recommend that the Commission recognises these differences in the business practices of distributors when writing requirements and guidelines. In many instances, the wording should be "*consumer or connection*" instead of just "*consumer*". For example, refer to our comments in paragraph 12 in relation to Requirement 28.

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- 9 The drafted date of 1 July 2006 for the requirements coming into force in clause 1(2) on page 2 will need to be changed to a later date, after the consultation process is completed.
- 10 Requirement 25 – Interpretation. We submit some comments on the draft definitions, as follows:

Depreciation

- 10.1 As there may be some conflict between assets' useful lives set out in the ODV Handbook and those as set out in the Commission's asset valuation roll-forward methodology, we suggest stipulating only those in the ODV Handbook.
- 10.2 To aid understanding and usefulness of disclosures by all distributors, we submit that ODV-based depreciation must be used, not accounting depreciation.

Key components

- 10.3 We submit that expenditure on administration, overheads, operations and maintenance should all be combined together under one category of operational expenditure, not two categories, for the reasons explained in the following paragraphs.
- 10.4 We note that distributors have taken a wide variety of different approaches to the allocation of costs into the "direct" and "indirect" split required by the financial performance measures contained in the Information Disclosure Requirements. This is particularly an issue for those distributors who contract out much of their maintenance, compared with those who operate an "in-house" model. We understand that as a result of various submissions and recent workshops, the Commission is likely to remove this notional indirect/direct split when the current revision is completed, which we support.
- 10.5 The paper's proposal for operational expenditure to be split into "*operations and maintenance*" and "*administration and overheads*" is, without very extensive prescription, likely to cause a similar distortion and provide information which is of very little benefit on either an individual company basis, or an inter-company comparison basis.

- 10.6 Accordingly, we recommend removal of the proposed arbitrary split of expenditure between “*operations and maintenance*” and “*administration and overheads*”, and replace them with disclosure of the combined total of these items.
- 10.7 As also noted below in our comments regarding taxation expense, the total distribution operating expenditure is essentially a budget/forecast for the period for which prices are being determined, and accordingly we recommend that the cost allocation methodology used to determine the total distribution operating cost also be consistent with the cost allocation methodology required by the Information Disclosure Requirements.

Taxation costs

- 10.8 We submit that taxation should be calculated using ODV-based depreciation.
- 10.9 In our view, projections of expenditure, such as taxation, should be determined by distributors on a basis that is consistent with that which is used in the determination of a distributor’s regulatory ROI (which would also be used by the Commission in the event of any post-breach investigation). The Commission held a number of workshops on financial disclosures during 2005, but the determination of tax expense was not included in those discussions.
- 10.10 We have previously submitted on the appropriate method for calculating regulatory tax expense for a distributor in our submission dated 25 February 2005 entitled “*Review of the Information Disclosure Regime Discussion Paper*”. In that submission, we argued extensively that the tax expense reported should be based on the tax position of an averagely-efficient new entrant (page 14), and “*therefore, as a starting point, tax expense should be calculated based on the regulatory financial statements, and should comply with GAAP*”. In the pricing methodology and price derivation context, the forecast tax should also be on this notional basis, not on the basis of actual forecast tax expense which the distributor expects to pay. Notional tax expense forecasts should also consider the treatment of financing costs, depreciation (refer below) and any rebates or discounts.

10.11 As noted in our previous submission, “consistency is also required as far as the treatment of tax depreciation. An efficient new entrant would have the considerable advantage of buying existing assets (at potentially significantly more than the ODV of the assets) or constructing new assets. Both of these methods will result in a considerably larger tax depreciation deduction than that available to an existing business which has held the assets for many years, or a business which was acquired through the purchase of shares. To encourage consistency with the efficient new entrant test, between line businesses and over time, we recommend that for the derivation of tax expense, ODV depreciation should replace actual network fixed asset tax depreciation.

Alternatively, the Commission may wish to consider a simplifying tax calculation, of the form:

Tax expense = (surplus before depreciation and tax less ODV depreciation) multiplied by the corporate tax rate.”

Transmission costs

- 10.12 We submit that this definition should be aligned with the distribution thresholds notice, particularly in relation to the definition of “avoided transmission” costs (including the cost of capital).
- 11 *Requirement 27 – Disclosure of change to pricing methodology or line charges.* There is an error in the drafting of clause (2). In the paragraphs that follow, we suggest corrections of deleting the first (b) and shifting the ‘or’ just before the second (b) out to a paragraph on its own.
- 12 *Requirement 28 – Information to be disclosed and published.* This is a particular part where we consider that “consumer” needs to be changed to “consumer or connection” as the pricing derivation is based on consumer groups or connection groups. Alternatively, the reference could be to “pricing groups” as a generic term to cover connection categories, load groups or consumer market segments.
- 13 *Requirement 28(e) –* This is a particular part where we consider that “charge” needs to be changed to “price”, in all cases except in 28(e)(iv).

- 14 *Requirement 28(e)(iv)* – We suggest replacing the words “*which are fixed and the proportion which are variable*” with “*which are collected through each pricing component applied (eg fixed and variable)*”. This broader categorisation would then cater, for example, for demand-based charges (c/kW/day) in respect of major customer connections, which are different to both fixed (c/day) and variable (c/kWh) charges.

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- 15 *Clause 5.2.4*. We appreciate the acknowledgement of the two approaches used by distributors for pricing – GXP-based and ICP-based. However, we suggest some improvements to this clause, as follows:
- It is not relevant and generally incorrect to state that the two approaches “*result in different distribution costs (and hence revenue requirements)*”. The key difference is in the load groupings used for pricing. Generally, these are connection categories for GXP-based pricing and consumer segments for ICP-based pricing.
 - The “*under interposed arrangements*” is out of context and not relevant. Both GXP-based pricing and ICP-based pricing can apply under interposed arrangements.
 - In the last sentence, replace “*derive*” with “*recover*” and delete “*to determine the consumer grouping*”.
- 16 *Clause 5.2.6 (a)*. In the first sentence, we suggest adding “*or connection*” after “*consumer*”. Of more significance though, Orion maintains two pricing zones that exhibit very different cost drivers:
- an urban zone that peaks in winter; and
 - a rural zone that peaks in summer.
- 17 While we apply substantially the same prices in both zones, the proposed information disclosure and requirement to separate costs may highlight the different return on capital received in each zone. As an unintended consequence, distributors may be pressured to standardise these returns, which appears contrary to the Government Policy Statement (section 99), which expects “*changes in rural line charges in line with urban line charges*”. Please also refer to our comments ahead on Clause 5.3.2.

- 18 *Clause 5.3.1.* Further to our previous comments under “*interpretation*” in this submission, we recommend combining components together of (e) “*operations & maintenance*” and (f) “*administration & overheads*”. The breakdown of these components is available in the distributors’ separate regulatory financial statement disclosures.
- 19 *Clause 5.3.1.* We submit that there needs to be another row in this table to state the value of capital contributions (cash and non-cash) for network extensions expected from customers.
- 20 *Clause 5.3.2.* The proposed template does not appear to provide for any differentiation between derived versus applied prices. Differences are likely for various reasons (eg to meet price threshold constraints, historical precedents, to avoid price shocks or to accommodate urban/rural pricing constraints in the GPS). We suggest that this could be done by having an extra row for shortfalls, over-recovery or transfers between consumer or connection groups. It would be appropriate for distributors to provide an explanation in respect of any significant entries in this row. Separately, factors which affect overall target revenue (usually in terms of a shortfall) could be added as a component in the table in 5.3.1.
- 21 *Clause 5.3.2.* Is the template mandatory or just the information in it? We would suggest and prefer the latter as we think that we can improve the layout, without losing any content.
- 22 *Clause 5.3.2.* Assuming that the last two rows (% Fixed and % Variable) refer to the basis of proportions of revenue collected, we suggest that distributors should add further rows to reflect each of the price components that they use to recover their targeted revenue. Please refer also to paragraph 14 above regarding Requirement 28 (e)(iv).
- 23 *Clause 5.4.1.* We consider that the terminology should be changed (ie replace “*consumer*” with “*consumer or connection*” and replace “*charge*” with “*price*” in step 5).
- 24 *Clause 5.4.3.* We question what relevance the “*effective unit rate*” has in the last sentence. Apart from being an artificial result, the annual network cost per total energy delivered is not an appropriate measure for comparisons of prices between consumers, connection categories or distributors. This is because distribution costs are driven primarily by peak loading (ie rate of delivery) and not by total energy (ie how much is delivered).

Response to Questions from the Commission (clause 18 in the Consultation Paper)

- 25 *Do the revisions meet the purpose of the information disclosure regime?*
Yes, subject to the corrections we have detailed in this submission and with the addition of explicit recognition of historical transfers between consumer or connection groups and a distributor's under or over-recovery for other reasons (eg a distributor's decision to comply with distribution price threshold restraints), Orion believes that the revisions meet the purpose of the information disclosure regime.
- 26 *Do ELBs have the information available to comply fully with the new requirements for this financial year?* Although the disclosures will require some analytical work, Orion has the information available to comply. However, noting our concerns about operating expenses and taxation (paragraphs 10.1 to 10.10), if these items are to be calculated on a basis that is consistent with the Information Disclosure Requirements, then we will require details of the Information Disclosure package first.
- 27 *To what extent do the revisions increase compliance costs for the ELB?*
We are concerned about compliance costs, which are high, but we do not consider that the new requirements significantly increase the compliance costs compared with the cost of meeting the current requirements.
- 28 *Does the new section to the Handbook aid understanding?* Yes, subject to the appropriate corrections and other recommended changes that we have detailed above.

Conclusion

- 29 Thank you for the opportunity to make this submission. We look forward to receiving the updated revisions from the Commission in due course. If you have any questions relating to this submission, please contact Neville Ross (Commercial Contracts and Pricing Manager) on 03 363 9870 or email neville.ross@oriongroup.co.nz.

Yours sincerely



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