

29 May 2008

Mr Gerry Brownlee MP
Chair
Commerce Select Committee
Parliament Buildings
Wellington

Dear Mr Brownlee

COMMERCE AMENDMENT BILL 2008 SUPPLEMENTARY SUBMISSION

On 22 May 2008, Orion presented an oral submission to the Commerce Select Committee (the Committee) on the Commerce Amendment Bill 2008 (Bill). During that presentation the Committee requested Orion to provide a supplementary submission expanding on an example that was used during the hearing to illustrate the potential uncertainties relating to the content of input methodologies, and in particular the input methodology for the valuation of assets. This supplementary submission:

1. describes the approaches the Commerce Commission (Commission) might take to formulating the input methodology for establishing regulated asset values;
2. describes differentiating factors between individual electricity lines businesses (ELBs) that should influence the manner in which the Commission seeks to *apply* its asset valuation input methodology. The stony ground conditions in Canterbury is one such factor of particular relevance to Orion; and
3. comments on the consequences of this for appeal rights.

A. Approaches to asset valuation methodology under section 52S(1)(a)(ii)

The Bill as drafted requires only for the Commission to set an input methodology for “valuation of assets, including depreciation, and treatment of revaluations.” This gives the Commission a wide discretion in terms of its preferred approach to

asset valuation and the level of detail it chooses to include in the input methodology.

1 Preferred approach to asset valuation

The Bill provides the Commission with the flexibility to set out a range of different asset methodologies depending on the industry in question. In the past, it has illustrated a willingness to adopt different asset valuation methodologies across industries, for example, it has applied:

- an opportunity cost methodology for valuing airport land;
- historical cost based asset valuation principles for valuing specialised airport assets;
- an optimised depreciated value (ODV) approach for valuing electricity and gas networks assets; and
- a depreciated historical cost (DHC) for valuing electricity transmission assets.

As stated above, the current asset valuation methodology applicable to ELBs under Part 4A of the Commerce Act is the ODV approach as set out in the Commission's Handbook for ODV of System Fixed Assets (ODV Handbook). The ODV methodology seeks to ascertain the value of an ELB's assets at the start of the regulatory period by estimating the cost that would be incurred at that time by a hypothetical new entrant seeking to deploy modern equivalent assets.

For the purposes of this supplementary submission, we assume that the ODV methodology will remain the approach to asset valuation for ELBs, although we recognise this may not necessarily be the case.

2 Level of detail prescribed

The Commission could prepare an input methodology for asset valuation that is cast in high level terms, or it could prepare a very detailed methodology. The Bill as drafted would allow either course. We provide potential examples of both below.

High level input methodology

A prominent example of an asset input methodology that provides only high-level guidance is section 8.10 of the National Third Party Access Code

for Natural Gas Pipelines (known generally in Australia as the Gas Code), which deals with how regulated prices (ie, Reference Tariffs) should be established for those pipelines that are subject to price regulation (ie, Covered).

Section 8.10 (detailed below) deals with how to establish the initial regulatory value for pipeline assets (ie, the Initial Capital Base) that are already in place, but hitherto have not been covered under the Code. In this sense, it is perfectly analogous to the decision the Commission will need to make when first establishing binding price paths (whether customised or default) for ELBs. The section (and the Code generally) has the force of law, and so is analogous to an input methodology in the sense that it is binding on a regulator. It states

Initial Capital Base - Existing Pipelines

8.10 When a Reference Tariff is first proposed for a Reference Service provided by a Covered Pipeline that was in existence at the commencement of the Code, the following factors should be considered in establishing the initial Capital Base for that Pipeline:

- (a) the value that would result from taking the actual capital cost of the Covered Pipeline and subtracting the accumulated depreciation for those assets charged to Users (or thought to have been charged to Users) prior to the commencement of the Code;*
- (b) the value that would result from applying the "depreciated optimised replacement cost" methodology in valuing the Covered Pipeline;*
- (c) the value that would result from applying other well recognised asset valuation methodologies in valuing the Covered Pipeline;*
- (d) the advantages and disadvantages of each valuation methodology applied under paragraphs (a), (b) and (c);*
- (e) international best practice of Pipelines in comparable situations and the impact on the international competitiveness of energy consuming industries;*
- (f) the basis on which Tariffs have been (or appear to have been) set in the past, the economic depreciation of the Covered Pipeline, and the historical returns to the Service Provider from the Covered Pipeline;*

- (g) *the reasonable expectations of persons under the regulatory regime that applied to the Pipeline prior to the commencement of the Code;*
- (h) *the impact on the economically efficient utilisation of gas resources;*
- (i) *the comparability with the cost structure of new Pipelines that may compete with the Pipeline in question (for example, a Pipeline that may by-pass some or all of the Pipeline in question);*
- (j) *the price paid for any asset recently purchased by the Service Provider and the circumstances of that purchase; and*
- (k) *any other factors the Relevant Regulator considers relevant.*

Although the section appears a quite specific and detailed input methodology, it still offers wide discretion to a regulator as to what valuation approach should be adopted. In addition to the potential candidate valuation approaches listed above in sections 8.10(a) and (b), section 8.10(c) also provides a regulator with the flexibility to adopt any other 'well recognised asset valuation'. In other words, it is possible to define an input methodology that, on its face, is quite detailed that nevertheless leaves significant discretion for the regulator when it comes to apply it.

Given the amount of effort involved in developing input methodologies specific to particular industries, and even to specific firms within an industry, it is quite conceivable that the Commission will prepare methodologies in such a high level manner. This prospect is more likely if appeal rights continue to be limited to input methodologies. In such circumstances the Commission would have the clear incentive to preserve for itself as much discretion as possible when preparing methodologies. It could then exercise that discretion when making its final decision, without facing the prospect of appeal. This would not deliver the improved certainty and accountability sought by the Bill.

Detailed input methodology

The Commission's input methodology for the valuation of regulatory assets might also be set out in significant detail. As it happens, the current asset valuation methodology applicable to ELBs set out in the ODV Handbook is quite detailed. The 2004 Handbook was designed for information disclosure purposes and reflects many years of consultation and

development.¹ However, it was not intended for use in actual price control situations.

It would certainly be Orion's preference for input methodologies to be furnished with as much detail as possible so as to improve certainty. However, we recognise that it is unlikely to be possible to craft the methodology so as to cater for *every* conceivable factor that may affect an individual ELB's asset valuation. Even the ODV Handbook, comprehensive as it is, does not cater for every ELB-specific factor. Below we examine the significance of these differentiating factors for ELBs and their potential implications for the nature of appeal rights.

B. Differentiating factors for ELBs

Although ELBs provide what is effectively a homogeneous product, the operating environments in which that product is delivered can vary considerably between them. Distribution networks of comparable size and configuration can face different cost profiles and so different asset valuations for many reasons, including the meteorological and geographical characteristics of a region.

Orion faces a number of atypical factors that significantly increase the costs we incur in deploying and maintaining our regulated distribution assets. Perhaps the most notable of these factors is the stony ground conditions in Canterbury. Christchurch's "City Plan" does not provide for the construction of new overhead reticulation, effectively requiring us to install underground cabling. With much of the city built on ground that was once alluvial river bed, the costs associated with cabling can be much higher than in other areas.

The specific additional costs include:

- heavier machinery is required for trenching, and excavation takes longer;
- underground thrusting technologies, where cable installation is via horizontal boring, often cannot be used, requiring more excavation of trenches and subsequent reinstatement of high value surfaces; and
- the dry stony ground does not dissipate heat very well, preventing us from using cables at full capacity, and forcing us to install heavier cables.

¹ The original MED version of the ODV Handbook was produced in June 1994

There are many other local factors that can affect asset construction costs in different areas, not all of which are currently recognised in the ODV Handbook. The most significant factors are:

- traffic volumes and traffic management requirements;
- CBD locations with a high density of utilities, high-cost surfaces and restricted working hours;
- remote and rugged locations;
- overhead lines exposed to high wind or snow loadings; and
- underground cabling in rock.

Orion's concern is that, if the ODV approach to asset valuation remains in place for ELBs, then it seems rather unlikely that the input methodology prepared by the Commission would be sufficiently detailed to address up-front the stony ground issues we face. The more likely scenario is that the issue would be addressed *subsequently*, once the Commission sought to *apply* its methodology to value our regulatory assets.

Of course, if the Commission errs in that subsequent process we would have very little recourse under the Bill as drafted because appeal rights do not presently attach to final decisions. We expect that many other ELBs harbour similar concerns about how their particular differentiating factors feasibly could be captured in the Commission's asset valuation input methodology.

C. Consequences of this matter for appeal rights

The existence of ELB-specific factors incapable of being exhaustively captured in a single asset valuation methodology further highlights the need for appeal rights to attach to final decisions. As explained above, even a highly detailed methodology would be unlikely to address all potential asset valuation matters affecting each ELB. The Court would still be required to deal with hypothetical or abstract questions.

It would be unrealistic and unreasonable to expect a court to opine sensibly on an asset valuation methodology in these circumstances. How can the Court fulfil a meaningful review role if it does not know how the Commission will *apply* that methodology to a particular ELB and its idiosyncracies, eg, to Orion and its 'stony ground' issues? We cannot envisage how limiting appeal rights to input

methodology decisions would deliver the improved certainty and accountability sought by the Bill, given these circumstances.

All of the problems outlined above are overcome if appeal rights attach to final decisions (including the input methodologies underpinning those decisions), such as those relating to customised proposals. Every ELB (including Orion) would have the opportunity to argue that its asset valuation should reflect its particular circumstances, including geographical factors such as stony ground. The court would have before it all of the relevant facts and principles that may have been applied by the Commission in relation to the matter in question. It would therefore be able to make a fully informed decision.

Thank you for the opportunity to appear before you, and to add this further submission.

Yours sincerely

A handwritten signature in blue ink, appearing to be 'BK', followed by a period.

Brendan Kearney
Acting Chief Executive Officer