

7 August 2006

Network Performance Group  
Commerce Commission  
P.O. Box 2351  
Level 6, 44-52 The Terrace  
Wellington

*By email:* gas@comcom.govt.nz

Dear Paula

**AUTHORISATION FOR THE CONTROL OF SUPPLY OF NATURAL GAS  
DISTRIBUTION SERVICES BY VECTOR LTD AND POWERCO LTD: FORM OF  
CONTROL – DISCUSSION PAPER**

- 1 Orion welcomes the opportunity to make this submission in response to the above discussion paper.
- 2 We currently have no commercial interest in natural gas distribution services. However, the Commission's discussion paper addresses many issues that are likely to arise in potential control of electricity lines businesses, and so represents an important milestone in developing approaches to the control of energy network businesses generally.
- 3 Orion supports the Commission's broad approach outlined in the discussion paper. We particularly welcome the Commission's general support for incentive regulation approaches (rather than rate of return regulation) and its expressed intention to set the price control for natural gas distribution services by reference to the costs of the business, as determined under a building block framework.
- 4 We consider that the Commission's proposed framework will promote greater clarity and certainty as to the Commission's general regulatory approach. It will provide an important signal as to the future development of control for relevant electricity lines businesses; we emphasise that it is desirable to be consistent in the approach taken to control of electricity and gas network businesses.

- 5 Whilst generally supportive of the Commission's proposed approach, there are some aspects of the Commission's proposal which we believe warrant further development or clarification.
- 6 The specific question numbers from the discussion paper have been noted below, where relevant. We note that several of our comments apply more generally to the underlying framework being adopted for the form of control, rather than being responses to specific questions raised in the discussion paper.

**Price controls should be established by reference to the business' underlying costs**

- 7 We continue to support an approach whereby price controls (and price thresholds, where relevant) are determined by reference to an assessment of specific business' costs. We therefore welcome the Commission's intention to adopt this approach in establishing controls for the two gas distribution businesses.
- 8 We support the Commission's proposal to adopt a combination of an initial  $P_0$  adjustment together with X-factors for the subsequent years, with the X-factors being set to equate the building block revenue requirement and the price path, in NPV terms. Such an approach is a sound basis on which to ensure that a lines or gas distribution business has the opportunity to recover its efficient costs over the course of the price control period.
- 9 The Commission recognises in the discussion paper that the form of control is only one element of the task that needs to be addressed in moving forward with control for Vector and Powerco. Orion notes that the Commission intends to consult separately on the approach to the actual derivation of the building blocks, as part of its 'second work stream'. We also note that this will be addressed as part of the draft decision paper scheduled for release in December this year.
- 10 We believe it is critical to recognise that the details of this calculation and the approach taken by the Commission to determining the various components of the building blocks are of fundamental importance to ensure that the price control regime is effective and appropriate. Orion therefore urges the Commission to ensure that these aspects of the regime are fully set out and consulted on as part of its determination.
- 11 It is particularly important to this aspect of the framework that the  $P_0$  adjustment be derived by reference to realistic ODV asset values that reflect the cost of an averagely efficient new entrant at that location. The

ODV values to be adopted should allow the opportunity for company specific circumstances to be incorporated into the initial ODV value, even though this may represent a departure from industry standard unit cost estimates.

- 12 In addition, it is important that the WACC be set at a realistic level to provide adequate incentives for businesses to invest and allow for the asymmetric risk of underinvestment. It is also critical that the assessment of costs to be incorporated into the building block based NPV calculation ensures that firms with above average efficiency performance have the opportunity to earn above-WACC rates of return. Such opportunities, and the incentives that flow from them, are consistent with long term dynamic efficiency, as firms seek to out-perform in terms of both efficiency and service.

**Form of control should continue to allow pricing flexibility (Q17)**

- 13 We have some concerns that in some areas the form of control set out in the discussion paper risks becoming over-intrusive, with the result that it may stifle initiatives by the regulated businesses to adopt innovative tariff policies.
- 14 It is important that the price control mechanism imposed allows for innovation in the structure of tariffs since, in our experience, this is a very important element in achieving allocative, productive and dynamic efficiency. Pricing flexibility has been recognised by the Commission as an important criterion against which to assess alternative forms of control. Orion notes and supports the Commission's proposal to adopt a weighted average price control to be applied to standard services. However, we are concerned that the Commission appears from the discussion paper to be inclined to determine the 'efficient' structure of initial prices. In particular, the formula set out in the discussion paper relates proposed prices to the 'allowed' prices determined by the regulator.<sup>1</sup>
- 15 We consider that such an approach would be unnecessarily intrusive and would risk stifling individual business' initiatives in relation to tariff design. It would also require the Commission to collect extensive information on the costs of different services, as recognised in the discussion paper. A more usual approach to a weighted average price cap (such as those adopted in jurisdictions in Australia, and in the United Kingdom) is that

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<sup>1</sup> Discussion Paper, p. 69.

initial prices are determined as a percentage change from previous years' prices, rather than by reference to approved 'efficient tariffs'.

- 16 Such an approach is more suitable as it does not require the Commission to impose its own view of efficient tariffs and efficient tariff structure and continues to leave the responsibility for tariff design with the business itself. Provided that the form of control provides suitable incentives for efficient tariff design (which is an important property of the tariff basket form of control), then initial prices do not need to be imposed by the Commission. Rather, they can be allowed to evolve in response to the incentives provided and prevailing market conditions.

### **Side constraints (Q11, Q12)**

- 17 The consideration of side constraints also needs to recognise the importance of tariff flexibility. In our experience, it is important to allow for responsiveness in tariff design, as customer needs change. The imposition of side constraints that require prices to be within a band of previous prices has the potential to limit such responsiveness, particularly if constraints are placed on each tariff component rather than at an overall tariff level. This reduced flexibility needs to be considered alongside any perceived benefits from side constraints in terms of reducing customers' exposure to large price movements.

### **Use of correction mechanisms to share output risk (Q13)**

- 18 We support the criteria proposed by the Commission for evaluating alternative forms of control, namely pricing flexibility, output risk, efficiency and information. However, much of the Commission's detailed discussion on the form of control and the need for correction factors is related to concerns regarding 'output risk'. This discussion does not appear to give sufficient weight to the role of tariff structure in managing this risk. The role of tariffs in managing output risk – particularly that surrounding peak loads – has been a fundamental and very successful part of Orion's strategy for many years.
- 19 If tariffs are designed to reflect the key cost drivers for the network, then our experience is that business is less exposed to volume output risk, since revenues and costs move in line with changes in output. We believe there is a danger that, by ignoring or underplaying the role of efficient tariff design, the Commission will impose significant complexity in the control arrangement (for example through complex correction mechanisms) in attempting to achieve the same outcome.

- 20 As noted above, Orion believes that businesses themselves are best placed to design tariffs and therefore manage output risk.

### **Form of control for non-standard services (Q18)**

- 21 The Commission proposes that negotiated services be subject to a revenue cap, with no side constraints. This proposal recognises that, in the case of non-standard services, customers on these tariffs are large and have countervailing market power. Prices for such services are negotiated on an individual basis.
- 22 Given that customers on non-standard services do have a degree of countervailing market power, we question the need to impose a revenue cap on prices for those customers. We note that in the recently released draft rule determination for electricity transmission businesses in Australia, non-standard, negotiated services sit outside the main form of price control, and are instead subject to arbitration provisions in the event that negotiation is unsuccessful.<sup>2</sup> The decision to exclude these services from the scope of the main form of control was made on the basis that the customers for these services do have countervailing market power, and so a less intrusive (and less costly) form of price control can be adopted.
- 23 We recognise that, given a decision to move to control, the Commission may not have much flexibility as to the scope of services that are subject to control. Nevertheless, we believe that the Commission should consider alternative forms of price control – such as a negotiate/arbitrate arrangement – where the degree of countervailing power of large customers means there is the potential for improving the efficiency of the control arrangements.

### **Other features of the proposed control regime (Q4, Q8, Q9, Q10, Q16)**

- 24 The Commission sets out several other features of the proposed control regime in the discussion paper, such as:
- 24.1 a five year control period;
  - 24.2 a cost pass-through for certain defined, uncertain costs (transmission costs, regulatory levies, statutory levies); and

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<sup>2</sup> Australian Energy Market Commission, Draft Rule Determination, 26 July 2006.

- 24.3 no re-opening provisions ('shipwreck clauses').
- 25 Orion broadly supports all of the above features and the criteria put forward for the characteristics of the service standards which should be included in the control.<sup>3</sup>
- 26 However, we do not support the introduction of financial incentives for service quality. We note the Commission's concerns about the quality of information available on which to base these schemes, and recognition that this may be a practical impediment to implementation.
- 27 We also consider that customers can be better served in other ways, for example through our "over boundary maintenance service". Most distributors maintain electrical equipment up to the boundary of the property – beyond the boundary is the property owner's responsibility. We however commit to maintaining the lines, poles and all other electrical equipment right up to the point of entry to a house or business building<sup>4</sup>. We do this regardless of whether the electrical equipment between the boundary of the property and the building is owned by Orion, the property owner or a third party. We believe we are the only distributor to include this service in our price and consider that this service is more valuable to the customer than guaranteed service levels with direct compensation.
- 28 The Commission does not propose to introduce an efficiency carryover scheme to apply to gas distribution businesses. We note that this decision has been made in light of uncertain future regulatory arrangements that may apply to the gas distribution businesses, rather than any inherent difficulties with the operation of a carryover scheme per se. As such, any future decision on whether to impose an efficiency carryover scheme for electricity distributors that are to be subject to control would need to consider whether the same uncertainty applied.
- 29 Thank you for the opportunity to make this submission. If you have any questions, please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email [dennis.jones@oriongroup.co.nz](mailto:dennis.jones@oriongroup.co.nz).

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<sup>3</sup> These characteristics are set out on page 99 of the Commission's discussion paper.

<sup>4</sup> This service covers fair wear and tear, including storm damage, but does not cover damage caused by the customer or a third party. Further information on this service can be found in section 4 of our network code which is available on our website ([www.oriongroup.co.nz](http://www.oriongroup.co.nz)).

Yours faithfully

A handwritten signature in black ink, appearing to read 'R. Sutton', with a long horizontal flourish extending to the right.

Roger Sutton  
**Chief Executive Officer**