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Network Performance Group  
Networks Branch  
Commerce Commission  
PO Box 2351  
**Wellington**

**SUBMISSION ON -**

**UPDATED REPLACEMENT COST SCHEDULES FOR TRANSMISSION ASSETS**

- 1 This submission is provided in response to the Commerce Commission's (the *Commission*) "*Invitation for Submissions on Updated Replacement Cost Schedules for Transmission Assets*" dated 28 June 2006. This invitation refers to the paper prepared for the Commerce Commission by Parsons Brinckerhoff Associates entitled "*Review of Transpower's Standard Replacement Costs – ODV Valuations*" (the *paper*) dated June 2006.
- 2 We welcome this opportunity to comment on the paper.
- 3 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.

4 There are numerous references in the *paper*, for example on page 3, to "*the lowest quartile principle*", which was "*established by the Commission for the review of distribution system replacement costs*". Further, PB Associates state that "*it was generally applied to the range of top down project costs provided by the different distribution lines businesses*" and "*We still believe that it is a valid method to use as a proxy for efficiency when considering a range of tender prices for a specific project*". Orion totally rejects this approach of using the "*lowest quartile principle*". We concur with Transpower's view that there is no real basis for applying lower quartile costs to a situation such as tender prices. The use of this "principle" is news to us. We object to this approach because:

- As far as we are aware, there has been no transparency. It was never proposed or subjected to any consultation with the industry.
- There is no basis for this approach in the ODV Handbook or in the ODV process.
- In our view, it is invalid. The appropriate replacement cost to use is the average of what is available in practice because that is what is faced by the averagely efficient new entrant. It is unreasonable and inappropriate to value based on the lowest replacement costs available for all assets. This would be assuming that the "best of the best" is the standard measure, which is untenable.

Taking this approach is unrealistic and not representative of practice in the real world. We are particularly concerned about the use of this "principle" in relation to distribution system assets, as reported by PB Associates on page 3 of the *paper*. This may explain the low level of some replacement costs that have resulted in the updated ODV Handbook.

- 5 The debate between PB Associates and Transpower in the report shows the importance of fully describing what is assumed when determining the installed replacement cost of an asset. The lack of clarity on this from PB Associates has been the source of many misunderstandings over the asset replacement cost values in the ODV Handbook. We have experienced this issue in both written and verbal communications with the Commission's consultant, PB Associates, particularly with respect to cabling costs. We favour full transparency of what is being assumed.
- 6 As Transpower is the only transmission company in New Zealand, we suggest that their experience of costs of installed assets has to take precedence. We suggest that PB Associates needs to be realistic and take notice of the actual conditions faced by Transpower in NZ. Our view particularly applies to labour rates and associated costs in the NZ labour market, where what is available must apply. In general, it is not appropriate to value the cost of their installed assets as if they were built elsewhere because they just won't be.
- 7 PB Associate's response on page 7 of the *paper* reads "*The 5% contingency provision is based on the use of a lower quartile proxy for efficiency and assumes an industry average contingency of 10%.*" Again, we consider this to be inappropriate. The averagely efficient new entrant will face standard industry practice and therefore the 10% should be used.
- 8 Orion uses some of the transmission replacement costs in its ODV – for 66kV steel tower lines and for 66/11kV and 33/11kV power transformers. However, our concerns are more about the valuation principles than about their unit replacement costs.
- 9 We are concerned about the future role of the ODV Handbook in view of the Commission's earlier decisions<sup>1</sup> in principle in relation to the asset valuation methodology for Transpower

***"Decision in principle on Asset Valuation Method for Transpower System Fixed Assets***

*157 The Commission has decided in principle to require that system fixed assets for Transpower are valued using an Indexed Historic Cost method. In applying that method, the Commission will not review or otherwise disallow Transpower investment expenditure from being rolled into the asset base where it is satisfied that these projects, and their associated expenditures, have been deemed to be required and*

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<sup>1</sup> Commerce Commission "*Regulation of Electricity Lines Businesses Valuation of the Regulatory Asset Base Decision Paper*" 13 October 2005

*efficient under an independent assessment and review process, in which interested parties are adequately consulted and their views adequately taken into account.*

*158 The Commission intends to develop a Handbook for the application of an Indexed Historic Cost method for Transpower, taking account of independent expenditure review processes already in place.*

*159 The Commission's proposal will not to allow Transpower to choose a different valuation method.*

*160 The Commission will assess this decision in light of any implementation issues regarding the use of the IHC method arising from the development of Transpower's pricing methodology."*

- 10 We have previously indicated<sup>2</sup> that we consider that assets valuation on an Indexed Historic Cost basis does not provide a principled valuation method. We still believe that it will lead to less rigour and less information in establishing unit replacement costs as their relative value becomes less significant and the component costs of new investment assets will not be identified.
- 11 We now note that in Transpower's recent submission to the Electricity Commission, regarding their transmission pricing methodology, that their preferred valuation methodology for allocating connection costs is replacement cost.
- 12 We would like the Commission to provide some guidance on the future of the ODV handbook, as it relates to Transpower's assets, as this will have some impact on the rigour used to establish transmission assets replacement costs for any future valuation and/or pricing methodology.

## **Conclusion**

- 13 Thank you for the opportunity to make this submission. 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](mailto:neville.ross@oriongroup.co.nz).

Yours sincerely



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<sup>2</sup> Orion "Submission on Regulation of ELB's Implementing Valuation choice for system fixed assets", section 3, 24 December 2004.