

29 November 2006

Unison Post-Breach Inquiry
Network Performance Group
Networks Branch
Commerce Commission
PO Box 2351
Wellington

By email: electricity@comcom.govt.nz

**SUBMISSION ON DRAFT DECISION: REASONS FOR NOT DECLARING CONTROL
UNISON NETWORKS LIMITED**

- 1 Orion welcomes the opportunity to submit on the Commerce Commission's (the *Commission*) draft decision - reasons for not declaring control of *Unison Networks* (the *paper*).

Support of process

- 2 Overall, Orion continues to support the Commission's process that provides for an administrative settlement as an alternative to control. We outline our specific observations below.

Threshold more than a screening mechanism

- 3 We consider that the Commission has defined thresholds as much more than a 'screening mechanism, notwithstanding the Commission's observation that:

*"The thresholds are a screening mechanism for the Commission to identify lines businesses whose performance may warrant further examination, and if necessary, control of their prices, revenues and/or service quality"*¹

- 4 We reach this conclusion because the Commission has indicated that:

¹ Para 5 of the paper

- 4.1 where a business in breach of its existing price path threshold offers to comply with that threshold for the remainder of the regulatory period, and also to address any performance issues that led to the breach or any s57E concerns which were identified by the Commission in its intention to declare control, it could be consistent with the purpose statement - and with the regulatory stability and certainty objective of the Government policy statement (*GPS*) - for the Commission not to control prices to a lower level. Such might be the case even if profits were to significantly exceed (or be significantly below) the business's WACC range over the short term. This is because the price path threshold is intended to limit excessive profits, not to remove them entirely;²
- 4.2 there may be significant indirect benefits to the industry as a whole from accepting and implementing a settlement as opposed to imposing control - where a business commits to complying with its existing price path threshold for the remainder of the regulatory period, and any identified performance issues have been or will clearly be addressed;³ and
- 4.3 the Commission suggests these indirect benefits may occur because there may be positive impacts on both investment incentives and incentives to improve efficiency for the wider industry stemming from the regulatory certainty inherent in not varying from a medium-term (i.e., five-year) price path. Such indirect benefits to the industry as a whole may further outweigh any short-term benefits to the consumers of any single business from lower controlled prices.⁴
- 5 Orion considers that this emphasis on providing industry-wide signals in relation to investment and efficiency incentives, together with the requirement to provide regulatory stability and certainty and the Commission's reinforcement of its commitment to a medium term price path, indicates that the thresholds may be much more than a screening mechanism where they are offered as terms for an administrative settlement. We assume that the approach taken in the present case does not foreclose the possibility that in some future cases administrative settlements may be reached for prices in excess of the threshold; we consider that the Commission should clarify this issue. This approach would logically involve a need to reset the threshold in question, as we

² Para 135 of the paper

³ Para 139 of the paper

⁴ Ibid

discuss further below.

Limiting excessive profits

- 6 The Commission has confirmed that the intent of the regime is not to remove all excessive profits, but rather to limit the ability to earn excessive profits.⁵
- 7 The Commission has also explicitly stated that businesses have an incentive to outperform the efficiency gains implied in their price path threshold because, throughout the five-year regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their CPI-X price path. Allowing a distribution business to retain this higher level of returns also preserves the incentives for that business to make ongoing efficiency gains in subsequent periods. Orion agrees that the scheme of section 57E requires such an approach to be taken, because there is a need to allow some functional monopoly rents in order to provide incentives for efficient investment and innovation, as we have previously submitted.⁶

Dynamic and allocative efficiency

- 8 The Commission has indicated that it places significant weight on dynamic efficiency in comparison to the other dimensions of efficiency, given the importance of efficient investment for the long-term benefit of consumers. The Commission also notes that the importance of dynamic efficiency is emphasised in the recent GPS, which concerns the incentives of regulated businesses to invest in infrastructure.⁷
- 9 Orion agrees with the Commission that dynamic efficiency should carry the most significant weighting because, over time, under-investment increases the risk that a lines business may not be able to continue to provide services at a quality that reflects consumer demands.
- 10 We note that while the Intention Paper addressed allocative inefficiencies resulting from the disparity in the returns received from Unison's Hawkes Bay consumers and its Rotorua/Taupo consumers, the current paper places significant weight on the allocative efficiency gains that it considers will result from Unison's voluntary decision to address similar 'disparities' between customer groups as well (i.e. returns by customer group).

⁵ Para's 28, 135 and 205 of the paper

⁶ Orion, *Submission on Intention to Declare Control of Unison*, 28 October 2005

⁷ Para 134 of the paper

- 11 The touchstone for the Commission's analysis of this issue is the term 'cost reflective pricing', which it refers to in allocative efficiency rather than dynamic efficiency terms. Orion considers that costs in an electricity lines business are largely driven by the overall peak load that the network must supply together with the overall capacity that must be provided (that is, the number of connections and length of the network). For dynamic efficiency reasons, 'cost reflective pricing' should relate to these two factors.

Unison's 'cost of supply' model and PAWG

- 12 The Commission has accepted that Unison's 'cost of supply' model deviates from the PAWG models. Orion agrees that the Commission should accept large electricity lines business's (*LELB*) deviations from the PAWG conclusions for a number of reasons:
- 12.1 the Electricity Commission is expected to develop 'principles' or 'model approaches' to distribution pricing;⁸
 - 12.2 the PAWG work is only a possible input into the Electricity Commission's work;
 - 12.3 the PAWG recommendations are not definitive. They provide only a framework to meet the objectives in its guiding principles, primarily to:
 - (a) provide efficient price signals for utilisation of and investment in the network;
 - (b) relate to the level of service and reflect cost structures and risks and be easily understood; and
 - (c) encourage technology innovation.

⁸ Pricing Approaches Working Group, *Model Approaches to Distribution Pricing*, 2 February 2005.

PAWG has been funded by ENA and was established in response to a request from the Minister of Energy for the industry to establish model approaches to distribution pricing. The February 2005 report was submitted to the Electricity Commission following comments from distribution businesses, retailers and consumer representatives on an earlier draft (August 2004), given that the Electricity Commission is expected to develop principles or model approaches to distribution pricing (Government Policy Statement in Relation to Electricity Industry Governance, October 2006, paragraph 98).

They do not prescribe a single price methodology.⁹ As stated in paragraph 12.1 above, the final Electricity Commission output is not intended to be a definitive standard template either, but instead will be a set principles or non-binding model approaches.

Threshold reset

- 13 The Commission has indicated that it is open to resetting a price threshold upwards if it finds evidence that the price path threshold is not of itself sufficiently high to maintain appropriate investment incentives. If such evidence is found, the Commission might consider consulting on resetting the threshold upward (either on its own initiative, or as a consequence of evaluating a proposed settlement offer), even before the end of the current regulatory period. Orion welcomes this approach, as it may reduce unnecessary breaches and their associated costs where LELBs can present such evidence in advance of a breach situation.

2009 threshold reset

- 14 The Commission has not provided any insights into the 2009 reset in this paper, even though this settlement places greater significance on the 2009 reset.
- 15 The Commission through the settlement process is weighing the potential long-term industry wide benefits that may flow from the decision not to control Unison, against the short-term potential excess profits that may result from Unison's prices at the threshold being greater than those which may occur under control.
- 16 The Commission appears to be doing this on the basis that this may provide additional benefits to be shared with customers at the end of the regulatory period, but does not indicate how this may occur.
- 17 The Commission has indicated in the paper that it intends consulting with interested parties:
- 17.1 on the appropriate level of efficiency gains to be shared with consumers, and the mechanism for sharing such benefits, in the lead up to the 2009 threshold reset; and

⁹ Section 6.1 Pricing Approaches Working Group, *Model Approaches to Distribution Pricing*, 2 February 2005

- 17.2 issues relating to the reservations that Unison has raised in relation to the targeted control regime. The Commission noted that these issues relate to the industry as a whole, and not just to Unison, and therefore, where appropriate, the Commission would be seeking the views of interested parties (including Unison) on such issues in the context of other work, such as the review of the information disclosure regime and the reset of the thresholds from 2009.
- 18 Orion considers that this consultation process is extremely important to improve the certainty and stability of the regulatory regime. We look forward to engaging in this consultation at the earliest possible opportunity.

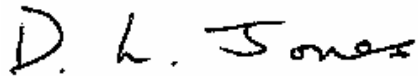
ODV

- 19 We note that the PBA report indicates that Unison provided two asset valuations. PBA commented in relation to these asset valuations that: ¹⁰
- 19.1 *The first valuation is an FRS-3 valuation based on current equipment procurement costs and the installation of assets in the normal course of business. This recognises that in the normal course of business Unison installs many new assets on a small scale or incremental basis and that very often additional costs must be incurred, for example through the use of live line construction techniques, to maintain supply while installation proceeds; and*
- 19.2 *In our view the FRS-3 valuation provides a useful basis for estimating the capital expenditure in the asset management plan budgets, which should logically be based on current costs and actual installation conditions.*
- 20 Orion agrees with the PBA comments above and encourages the Commission to use a consistent approach in relation to the ODV handbook, the Commission's information disclosure regime and any building block analysis or comparisons of returns against WACC.

¹⁰ PB Associates, *Review of 2006 Asset Management Plan Unison Networks Ltd*, section 3.1

- 21 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.

Yours sincerely

A handwritten signature in black ink that reads "D. L. Jones". The letters are cursive and slightly slanted to the right.

Dennis Jones
Industry Developments Manager