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Network Performance Branch
Commerce Commission
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**SUBMISSION ON PRELIMINARY VIEW TO NOT ACCEPT OFFERS OF
UNDERTAKING**

- 1 Orion welcomes the opportunity to make this submission on the Commission's preliminary decision to not accept offers of undertaking from Powerco and Vector.
- 2 Although Orion is not an active participant in the gas distribution sector, we have monitored with interest the Commission's decisions throughout the Authorisation process, particularly in respect to asset valuation, because similar issues arise for electricity distribution services providers.
- 3 In earlier submissions we have expressed concern at the approach taken by the Commission to establishing opening asset valuations for controlled gas distribution services – particularly the prospect of retrospective adjustments for so-called 'revaluation gains'. This latest decision does little to assuage those concerns.
- 4 The Commission's analysis of the settlement offers by Powerco and Vector is perfunctory, spanning less than three pages. It provides little explanation for its 'CPI-0' benchmark despite its criticality to the conclusions the Commission draws, and does not address in any material way the arguments put forward by the firms in support of their respective settlement offers.

- 5 Rather, the Commission rejects the proposals on the grounds that its benchmark 'CPI-0' price path would result in a lower forward-looking stream of revenue for each firm.
- 6 However, on this logic it would seem that any offer involving a price path that was greater in NPV terms than a 'scenario' established (but not properly explained) by the Commission would stand to be rejected. Orion believes this is an insufficient basis on which to make such an important decision.
- 7 Orion is also concerned at the Commission's continued rejection of the 25 August 2005 optimised deprival values (ODV) as the appropriate opening asset valuations for the purposes of establishing regulated prices in the longer term. It is still to provide an explanation sufficient to justify the retrospective revaluation adjustment contemplated in its Draft Decisions, creating significant ongoing uncertainty.
- 8 Rather, the principal attraction of the Commission's proposed approach to establishing opening asset values appears to be that it would significantly reduce prices.
- 9 Orion recognises that price reductions can play an important role in promoting efficiency and delivering benefits to acquirers of regulated services in some circumstances. However, lower prices are not beneficial *per se*.
- 10 The Commission cannot be permitted simply to 'cherry pick' an asset valuation that results in lower prices absent other principled bases for its selection. Indeed, it would be alarming if section 70A of the *Commerce Act 1986* (the Act) could be interpreted in such a way.
- 11 Orion has consistently reiterated the view that the opening asset valuation for controlled gas distribution services provided by Powerco and Vector should be based on their ODV as at 25 August 2005, consistent with:¹
 - 11.1 the fundamental economic principle that prices should reflect the opportunity cost of the resources displaced in providing services in the relevant market and so the promotion of competition for the long term benefit of consumers, consistent with section 1A of the Act;

¹ See NERA and Mark Berry, *Review of Commerce Commission's Draft Gas Distribution Services Decisions Paper: A Report for Orion New Zealand*, 30 November 2007 ('NERA and Berry (2007)').

- 11.2 safeguarding the interests of the acquirers of the controlled services from the excessive prices that might arise from an inappropriately *high* opening RAB, consistent with section 70A(b) of the Act;
 - 11.3 promoting efficiency in the production and supply of the controlled services by ensuring that the opening RAB is not set inappropriately *low* and so avoiding a scenario in which prices are set at or below a level that would warrant the imposition of control, consistent with section 70A(c) of the Act;
 - 11.4 the general scheme of Part 5, which contemplates the RAB being set as at the date control commences, without regard to valuations or methodologies that pre-date that time; and
 - 11.5 the Commission's February 2007 methodology for estimating the opening regulatory asset base (RAB), which stated that the opening value of the RAB at the start of the initial control period – 25 August 2005 – would be based on an optimised deprival valuation (ODV) carried out as at 30 June 2005.²
- 12 Moreover, as we have sought to highlight in previous submissions, the Commission's claims that its approach is consistent with the financial capital maintenance (FCM) concept³ and/or is necessary to place a hypothetical new entrant on an 'equal footing'⁴ with the incumbents are incorrect.
- 13 In Orion's view, if the Commission persists with its misplaced emphasis on setting RAB values that pre-date control, it would not be meeting its statutory obligations under the Act. Specifically, undertaking a retrospective adjustment to asset values would be:

² Commerce Commission, *Authorisation for the Supply of Natural Gas Distribution Services by Powerco and Vector: Valuation of the Opening Regulatory Asset Base, Valuation Methodology*, 15 February 2007, p2.

³ The FCM principle is *not relevant* to the initial valuation of the RAB. FCM is a *depreciation* concept that can be applied consistently to *any* initial opening RAB value. In itself, it has no bearing on *when* or *how* that initial RAB is set. It is also inconsistent with the general scheme of Part 5, which cannot be interpreted as allowing the retrospective adjustment the Commission proposes. See: NERA and Berry (2007), p19.

⁴ The opening asset value should to the greatest extent possible seek to place a *hypothetical new entrant of average efficiency* upon an equal footing with the incumbent, assessed on a *forward-looking basis as at the date of control*. Establishing opening asset values based on ODV estimates as at 25 August 2005 will achieve this outcome. It is not necessary to adjust those values to account for revaluation gains or losses prior to this date to ensure an 'equal footing' because such an adjustment cannot affect the (hypothetical) extent of competition on a forward-looking basis. See: NERA, Draft Decisions Conference: Cross-submission on behalf of Orion New Zealand, 14 March 2008.

- 13.1 inconsistent with the outcomes of a workably competitive market and so the promotion of competition for the long term benefits of consumers (section 1A);
 - 13.2 not necessary to safeguard the interests of acquirers of gas distribution services (section 70A(b)); and
 - 13.3 inconsistent with the promotion of long-term dynamic efficiency in the production and supply of those services (section 70A(c)).
- 14 In summary, Orion reemphasises its view that the opening RAB values should be based on the relevant ODV valuations as at *25 August 2005*, without any adjustment for 'revaluation gains' accruing prior to that date.
- 15 I do hope you find these thoughts helpful in your further deliberations on these matters of critical importance to the New Zealand energy sector, and I look forward to seeing further details as they develop.

Yours sincerely

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

Roger Sutton
Chief Executive Officer