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SUBMISSION ON INPUT METHODOLOGIES DISCUSSION PAPER

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the Input Methodologies discussion paper (the **IM paper**) released by the Commerce Commission (the **Commission**) in June 2009.
- 2 The Commission has put considerable effort into producing the recent default price-quality discussion paper (**DPP paper**), the information disclosure discussion paper (**IDP**) and this IM paper. We are pleased that the Commission is articulating its views on the broad package of regulatory changes, faced by a number of industries.
- 3 While the Commission has produced a significant amount of work, it remains extremely difficult to see just how the reforms will all fit together or impact on Orion. There remains considerable uncertainty in relation to the actual detail and the impact of a number of significant areas of the proposals.
- 4 The complexity of the proposals is due in no small part to the considerable timing and transitional issues of the legislation itself. Orion has commented on these issues previously to the Commerce Select Committee.
- 5 We believe that the sheer volume of the information that has been produced by the Commission and its complexity requires that we have much more time than the Commission has allocated to fully understand the proposal and to enable us to respond in a way which assists the Commission and the industry to produce a regulatory package that will be in the long term interests of consumers and meets the purpose statement in section 52A of the Commerce Act 1986.

- 6 We recommend that to the extent possible the Commission should slow down its current process and take advantage of the legislative provisions which provide the opportunity to spend an additional six months to develop the input methodologies.
- 7 We have not in this submission responded to any of the 298 questions posed by the Commission in its IM paper. This is primarily because Orion is still uncertain about many details of the input methodologies. In our view, the Commission is yet to set out various evaluation criteria relating to the CPP applications and the practical application of the input methodologies. For this reason we focus on the key issues of the IM paper rather than on answering particular questions.
- 8 Our submission is in two parts:
 - 8.1 our summary of the key issues; and
 - 8.2 our comments on specific chapters.

1. Summary of the key issues

The opening regulatory asset base (RAB)

- 9 Setting an appropriate opening RAB for EDBs is critical, since that value is likely to form an important input into any profitability calculation underpinning a P_0 adjustment and, to the extent that it forms a key input into any TFP calculation, it will also influence the annual rate of change in prices.
- 10 It remains our view that a first best case would involve beginning the new regime with an up-to-date 2010 ODV, with no adjustments for past revaluation gains. As we have submitted on a number of past occasions, an up-to-date ODV would reflect the cost that would be faced by a hypothetical new entrant supplanting an incumbent by deploying modern equivalent infrastructure, and this is therefore consistent with a contestable market outcome, which in turn is consistent with the purpose statement in section 52A.
- 11 We do not consider that the lack of an up-to-date ODV handbook is a reason for not carrying out an undated 2010 valuation. We consider that the Commission could adopt a principles-based handbook, which could have standardised optimisation approaches, standard lives etc, but the actual values could be left to the valuers and auditors to determine. This

would require the maximum level of transparency from each EDB in relation to the outcome.

- 12 Should the Commission decide against a new 2010 ODV then, as outlined in our submission on the DPP paper, Orion (reluctantly) accepts the Commission's preference for a 2004 ODV, rolled forward to 2010. However, that RAB should be updated to correct the significant deficiencies associated with that estimate prior to it being 'locked in'. These corrections may include:
- (a) quantity errors (assets omitted or included in error);
 - (b) categorisation errors (assets included but allocated to the incorrect asset category);
 - (c) age errors (assets included but allocated to the incorrect asset base);
 - (d) estimation errors (assets where estimates were made about quantity, age, category or location characteristics which are now known to be incorrect;
 - (e) an appropriate allowance for working capital;
 - (f) easements at their replacement cost value; and
 - (g) changes to multipliers

- 13 We also consider that the replacement cost values in the 2004 handbook were incorrect (too low), and that these values are likely to be difficult to correct due to the passage of time. We recommend that the Commission consider other ways to address this issue. One method that would partially assist is to extend the range allowed for multipliers to compensate for the low replacement cost values. However these problems indicate why the use of a 2004 valuation will be a "second best" substitute for an up-to-date 2010 valuation.

Roll forward methodology

- 14 The Commission has proposed to roll forward the RAB using CPI plus capex minus straight-line depreciation and disposals. There are several aspects of the Commission's proposal with which Orion agrees – at least in principle – namely:

- 14.1 we agree that the most pragmatic and straightforward means by which to depreciate the RAB over time is by means of straight-line depreciation.
- 14.2 we agree that in the context of a customised price path (CPP) any departure from ODV is likely to require the Commission to assess the prudence of capital expenditure – either on an ex-ante or ex-post basis – although:
- (i) the Commission should be mindful of the well-recognised proscription against hindsight in any ex-post prudence review; and
 - (ii) the Commission should not look back too far, since it inevitably will be difficult to assess the efficiency of capex from many years ago;
- 14.3 we agree that for the default price path (DPP) the Commission should pay close and careful attention to EDBs' asset management plans (AMPs) for the purposes of assessing the ex-ante prudence of capex. In our view, AMPs can provide the ex-ante discipline that is required under the DPP – no other formal mechanism is needed.
- 15 We do not support the Commission's proposal to use an indexed roll-forward approach (indexed historic cost (IHC)). Rather, we support an un-indexed roll-forward approach (depreciated historic cost approach (DHC)). It is our view that such an approach reduces commercial and regulatory risks for EDBs, therefore providing more certainty and better promoting the objectives of the Act.
- 16 We would support the development of a roll-forward (historic) cost handbook, but would prefer such a document to be 'principles based' to the greatest extent possible, rather than reliant on prescriptive rules. We are concerned that the description of the requirements for a historic cost handbook¹ and the detail required in preparing a historic cost handbook may be similar to that required to prepare an updated ODV handbook.

Pricing methodologies and cost allocation within business units

- 17 We have recently provided a submission to the Electricity Commission (EC) on this issue.² In summary, the EC's paper proposed the voluntary

¹ See paragraphs 6.268 to 6.292 of the IM paper

² <http://www.electricitycommission.govt.nz/pdfs/submissions/pdfstransmission/distrib-pricing/OrionGroup.pdf>

adoption of a detailed distribution pricing methodology based on a single retail based pricing model (RDM), with the threat of regulation if not adopted by the industry.

18 In brief: we did not agree with the ECs preferred approach of a RDM. We recommend that:

- (a) the EC adopt a set of principles that ELBs should take into account when developing their own pricing methodologies;
- (b) the EC should use the Commerce Commission's pricing principles³ as a starting point for developing the set of principles;
- (c) the pricing principles should be consistent with the preliminary views of the Commerce Commission that:
 - (i) in relation to the DPP, the costs associated with applying pricing methodologies to the default price-quality paths may outweigh the benefits; and
 - (ii) in relation to the CPP, that a principles-based approach to pricing methodologies is appropriate for ELBs;

19 We consider that the Commission should develop in conjunction with the EC a set of pricing principles for EDB's to follow, rather than implementing a prescriptive approach. Those pricing principles should reflect the principles proposed in the Commerce Commission's gas authorisation decision paper as reproduced in Table 13.5 of the Commerce Commission's input methodologies discussion paper.

Cost allocation between business units

20 Because Orion has extremely limited involvement in the day-to-day control of other companies, we are relatively unaffected (at least at present) by the Commission's cost allocation methodology. We agree that:

- floor/ceiling bounds are appropriate;
- costs should be allocated on a causal basis where practicable;

³ See paragraph 9.63 of the IM paper.

- it is desirable to allow some double counting of common costs in mergers so that efficient transactions are not discouraged; and
- consistency is important.

21 However, we do potentially take issue with several specific aspects of the Commission's proposal, namely:

- the Commission's dismissal of the ACAM is potentially too hasty – in our view ACAM is a sound way of allocating costs between regulated and unregulated business units; and
- the Commission should clearly articulate the circumstances in which the common cost savings arising from mergers will be retained by the merged firm – one approach would be allow the firm to retain such benefits for a set period, eg, 10-years.

Taxation issues

22 On tax issues, we believe that, of the options canvassed by the Commission, tax expense is best. The Commission is concerned that the tax expense method inappropriately allows early recovery by EDBs, but a similar criticism can be levelled that the opposite is true of tax payable. In an environment where EDBs' risks are increasing as demand-side measures are set to impact on network economics, it is not clear that tax payable can be preferred for any reason other than it is contrary to the commercial interests of the EDBs and therefore a short term "win" for consumers. It is not the Commission's role to secure wins for consumers at EDBs' expense. The Commission must achieve an appropriate balance of section 52A considerations.

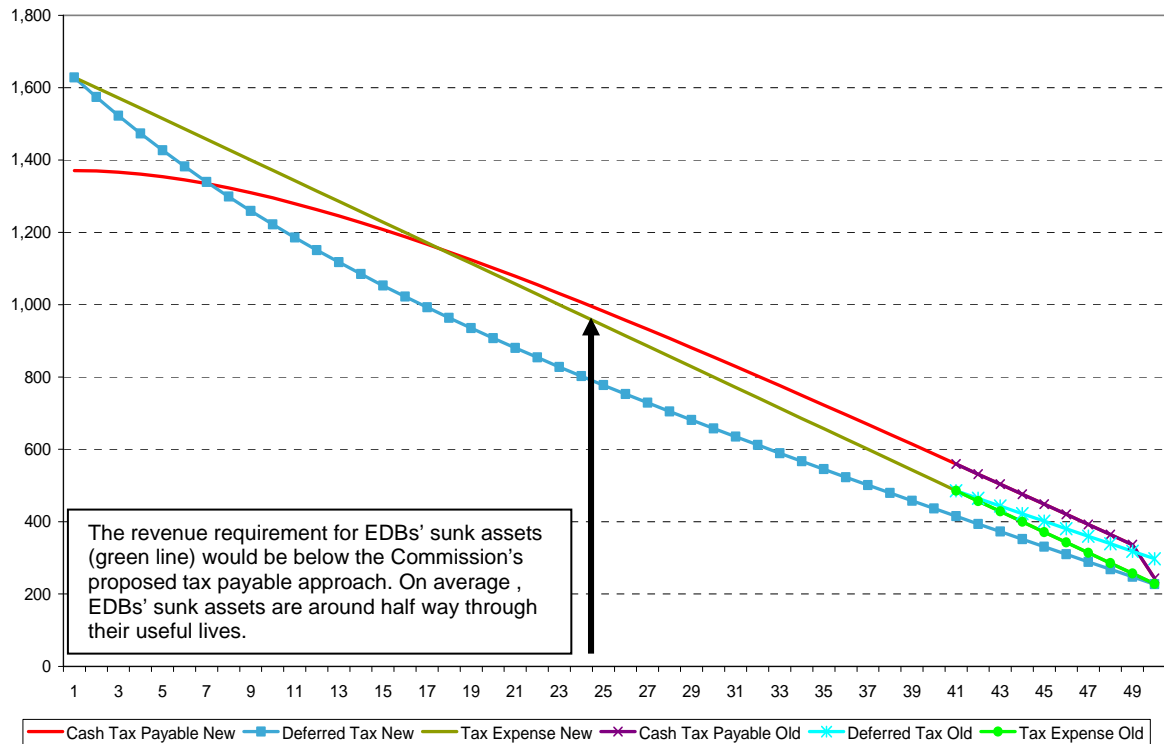
23 We are also aware that the ENA has asked PwC to prepare a report comparing the various options proposed by the Commission. We generally endorse this work and overall we consider that the tax expense approach has a number of advantages:

- 23.1 it smooths revenues over time;
- 23.2 it incentivises investment;
- 23.3 it is simpler to implement and is very transparent;
- 23.4 it exposes the industry to less volatility; and

23.5 has less risk for EDBs around changing regulation and more certainty for investment.

24 In Orion’s case, and we believe for many other EDBs, because of our very large sunk assets and their average age, the revenue requirement for a tax payable approach is very close to (in fact just below) tax expense for those sunk assets, as illustrated in Figure 1 below. On this basis alone we would recommend that the Commission should adopt the tax expense approach in order to keep it simple.

Figure 1 Comparison – Tax Methods Applied at Start of Life and with 10 years Remaining Life



Cost of capital

25 There are some aspects of the Commission’s draft IM on the cost of capital that are welcome. For example, it is encouraging to see that the Commission has given recognition to the widespread consequences of the global financial crisis and that it is open to considering its effect on

parameter estimates.⁴ We are also pleased to see that the Commission is open to providing compensation for real options, ie, 'Type II risks'.⁵

However, certain aspects of the Commission's preliminary proposal are troubling, including:

- why the Commission has chosen the Brennan-Lally capital asset pricing model (CAPM) when the majority of its expert panel members recommended something else;
- the Commission's proposed approach to calculating the cost of debt is also problematic; and
- use of the 75th percentile to account for multiple aspects of risk.

Proposals for customised price paths: process

- 26 We urge the Commission to ensure that the DPP process is sufficiently robust that it adequately captures a wide variety of EDB situations. If businesses are "defaulted" into applying for a CPP (a process likely to be relatively high-cost) the statutory objectives of Part 4 will be undermined. CPPs should be a last resort, not a remedy for defects in the DPP.
- 27 That said, a CPP may be useful to ensure the Part 4 purposes are achieved in circumstances where the application of the DPP to an EDB might be unsuitable or particularly harsh. With this objective in mind we wish to make the following points about the draft CPP process.
- 28 We do not agree with the Commission's proposal to provide only a one-week "window" for submitting a CPP proposal. Whilst this may make assessing CPP applications administratively convenient it is not required by the legislation. In our view it should not be adopted by the Commission. Nor should the Commission take too stringent an approach to "completeness" – in circumstances where an EDB may apply for a CPP only once in each regulatory period we submit that the Commission should rely primarily on its power to request further information before it shuts the gate on a particular proposal.

⁴ See paragraph 8.132 of the IM paper

⁵ See paragraphs 8.71-8.78 of the IM paper

Proposals for customised price paths: requirements

- 29 The legislative provisions which set out the Commission's obligations to publish input methodologies and determinations about CPP requirements are, to say the least, difficult to interpret. Errors of drafting in the legislation lead to uncertainty as to exactly how the CPP requirements will be set by the Commission. We urge the Commission to seek the necessary legislative corrections as soon as possible so that the process and requirements for CPP proposals can be made certain.
- 30 Once this legislative amendment has occurred, it will then be time to consider the requirements of a CPP proposal.
- 31 We submit that the input methodologies for CPP requirements should be furnished in as much detail as practicable to enable businesses to assess the detail required and how a proposal will be evaluated by the Commission. While we welcome the Commission's preliminary views as to requirements, we consider the absence of evaluative criteria means an EDB is in practical terms unable to determine how a proposal will be treated and its likelihood of success. The legislation requires the Commission to set out those criteria – without them, the CPP process (and its outcome for a given business) remains highly uncertain.

2. Comments on specific chapters

CHAPTER 2 – STATUTORY FRAMEWORK AND REGULATORY FRAMEWORK PRINCIPLES

- 32 In relation to chapter 2 we broadly support the Commission's view of the statutory framework and regulatory principles. There is however one issue that we consider problematic and wish to raise at this early stage because it may have practical consequences in the administration of the Part 4 regime. It turns on the definition of "consumer" in s 54C(4).
- 33 Section 52C of the Act defines "consumer" as a person that consumes or acquires regulated goods or services. Section 54C(4) provides that for subpart 9 'consumer' has the same meaning as in s 2(1) of the Electricity Act 1992. Under the Electricity Act 1992, a 'consumer' is any person who is supplied, or who applies to be supplied, with electricity. This definition does not include electricity generators, distributors and retailers, unless they apply to be supplied with electricity for their own use and not for resupply.
- 34 The Government has for a number of years been encouraging distributed generation, and EDBs' approach to this is now covered by regulation, which includes restrictions on the way that EDBs price to distributed generators. Orion is comfortable with this approach and has been an advocate of simplifying the connection process for distributed generation.
- 35 However, it is unclear in relation to the Part 4 regulation, what the implications are of having generators (who are not consumers as defined by Part 4) connected to a distribution network and using distribution assets.
- 36 While the penetration of distributed generation is at present relatively small in the Orion network it provides a useful complement to load management, significant increased generation on the network has the potential to impact on quality and reliability and to alter the design of the distribution network. In this respect distribution networks may become over time more like the transmission grid, providing a means of balancing changing demand and supply patterns rather than simply being a one-way service and providing a stronger element of back up supply for those times when such generation is unavailable.
- 37 These issues have potential impacts in relation to:
- 37.1 the correct assignment of assets to the RAB;

- 37.2 how payments to such generators are handled in terms of allowable revenue; and
- 37.3 potential price increase required to customers to meet a network that is sized to accommodate distributed generation.
- 38 Issues may also occur in relation to embedded networks owned by distributors, these embedded networks are currently treated as a customer by Orion however they may not be customers under Part 4. In this case it is unclear how the price – quality regulation will apply to these embedded networks.
- 39 A further issue that the Commission may want to consider is whether the definition of “consumer” can be meaningfully applied to transmission where debates about who uses the transmission system and particular components of it, have continued for many years, and where there are a number of network elements where electricity can flow in either direction.
- 40 We submit that the definition of consumer and the implied restriction of delivery service only to users of electricity may already be, and is likely to become, increasingly problematic. It may be that the Electricity Act is changed to reflect this in due course.

CHAPTER 4 - ROLE OF REGULATORY INSTRUMENTS AND INPUT METHODOLOGIES

Relationship of input methodologies to regulatory instruments

- 41 The Commission is undoubtedly correct to focus on the promotion of certainty as the primary purpose of input methodologies. Certainty is an important factor in promoting investment, innovation and efficiency gains. As we have previously noted in our submission on the Bill which became the Commerce Amendment Act 2008, it is our preference for the input methodologies to be furnished with as much detail as possible so as to improve certainty.⁶ We are comfortable with a relatively detailed approach being taken in relation to certain aspects of s 52T: for elements such as WACC clarity and specificity will be required to ensure there is sufficient certainty. The touchstone is always to ensure that a supplier is reasonably able to estimate the material effects of a particular methodology on its business.

⁶ Orion New Zealand Limited *Commerce Amendment Bill 2008 Supplementary Submission 29* May 2008 at p 5.

- 42 The appropriate level of detail is, however, inevitably informed by the subject matter of the particular input methodology: some will lend themselves to more specificity than others. For some methodologies there may be no need to prescribe in a high level of detail exactly how each element should be *applied* by a supplier.
- 43 We consider this is particularly the case for elements which touch on commercial flexibility such as pricing methodologies. A broad range of pricing models might be compliant with the pricing methodology. That said, the Commission should be careful to ensure in determining an input methodology for pricing (or similar) it does not preclude an EDB from exercising commercial judgement – or, worse, render a breach likely because of a “technical” departure from the methodology. The purpose contained in s 52R does not require absolute specificity within each IM determination, but instead is an overarching objective which must always be kept in mind by the Commission. Any determination which is too highly prescriptive may (perversely) cut against the purpose of promoting certainty rather than being in favour of it.

Switching paths

- 44 The Commission’s preliminary view is that an EDB switching between default and customised price-paths a number of times may make the implementation of input methodologies difficult. In our view this concern is significantly overstated. The legislation sets out in detail the circumstances in which a “switch” is permitted:
- 44.1 a CPP may be proposed only once in a regulatory period; and
- 44.2 once a CPP is proposed (and set by the Commission) it is binding on an EDB for the duration of the regulatory period.
- 45 We submit that the safeguards in the legislation against switching paths are sufficient. And it must always be kept in mind that an EDB may *at any time after a DPP is set* apply for a customised path.
- 46 Inferences beyond the words of the Act about what is “problematic” are not useful, especially when no practices have emerged about CPP proposals or the frequency of switches. In practice, the decision to switch paths will not be lightly undertaken – especially where a CPP proposal may only be made once in a regulatory period, so an applicant EDB will have a strong incentive to get it right the first time. And where evaluation of a CPP proposal requires a full building blocks analysis to be undertaken (with the attendant time and monetary expense being borne by the applicant, not by the Commission) it is unlikely a business would engage in the CPP

exercise and then shortly afterwards seek to change paths. In any event it is premature to attempt to define “how often is too often”.

Shipwreck clauses

- 47 We agree that re-opening of a price-quality path may be necessary to account for unforeseen and uncontrollable changes in circumstances. Such unforeseen events might well be of sufficient magnitude to render the price path no longer appropriate for a supplier. The criteria set out by the Commission (and quoted from the AER paper)⁷ as the characteristics of an event leading to re-opening are, in our view, broadly appropriate. Plainly such events must be outside the supplier’s control (and have a material impact on the controlled business) before a price path can be re-opened.⁸
- 48 However, we do not support fixing a materiality threshold for such events. This is because:
- 48.1 events requiring re-opening are by their nature unforeseeable and uncontrollable. While we would certainly not expect any adverse event, no matter how small, to lead to re-opening, it is problematic to define in advance the magnitude of an event which will. An EDB will have to make its case to the Commission that the loss was uncontrollable (and, we assume, also show it was uninsurable) and that re-opening is required. While a percentage of revenue measure might be a useful shorthand, it does not inform whether re-opening should occur in a particular case;
 - 48.2 a materiality threshold risks having events which otherwise meet the re-opener “test” but are just short of the threshold going uncompensated, despite serious adverse consequences on an EDB; and
 - 48.3 there is a moral hazard if EDBs know they are only required to protect against losses to a certain level but beyond that re-opening is a virtual “certainty” because the threshold is exceeded.
- 49 We urge the Commission to have reference to the AER criteria as indicators of the *types* of events which would warrant re-opening, but does

⁷ See paragraph 4.120 of the IM paper, quoting the Australian Energy Regulator (AER) *Statement of principles for the regulation of electricity transmission revenues, Position paper: Pass-throughs and revenue-cap re-openers* (December 2005) at 14-15.

⁸ We note also the legislation provides that a price-quality path may only be reopened as a consequence of a change in an input methodology if that change would have resulted in a “materially different” path being set: s 53ZB.

not consider that setting a materiality threshold is necessary. Each EDB (or a number of EDBs) will have to contend for re-opening and show an event was truly uncontrollable and had a material impact on the business.

CHAPTER 5 - COST ALLOCATION BETWEEN BUSINESS UNITS

50 Because Orion has limited involvement in the day to day control of other companies⁹, we are relatively unaffected (at least at present) by the Commission's cost allocation methodology. However, because such rules have a significant effect on our future incentives to invest, below we have set out our views on certain aspects of the Commission's proposals. We agree that:

50.1 floor/ceiling bounds are appropriate;

50.2 costs should be allocated on a causal basis where practicable;

50.3 it is desirable to allow some double counting of common costs in mergers so that efficient transactions are not discouraged ; and

50.4 consistency is important.

51 We are also cognisant of the fact that several as yet undeveloped details of the Commission's proposal are likely to significantly influence its effectiveness, namely:

51.1 the materiality threshold for determining when an ACAM may not be used to allocate costs to an unregulated business unit, although, we agree with the Commission's preliminary view that the threshold should be 'high' so as to allow regulated suppliers to retain any benefits arising from economies of scope associated with investments in unregulated services , but have no suggestions as to precisely what that threshold should be; and

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Group entities	Notes	Effective ownership 2009
Connetics Limited	Subsidiary – contestable business with full corporate separation operating in a contestable market	100% subsidiary
4RF Communications Limited	Associate	26%
Orion New Zealand Ventures Limited	Subsidiary – holds investment in US technology fund	100% subsidiary
Whisper Tech Limited	Investment	4%

- 51.2 the appropriate level of prescription – we agree that there is a trade-off between ensuring consistency on the one hand, and imposing undue regulatory compliance costs on the other, and our preference would be for a less prescriptive approach, consistent with the high-level approach adopted by the AER in Australia.¹⁰
- 52 However, there are some aspects of the Commission's proposal that we do not necessarily agree with. In particular, we believe that maintaining incentives to invest should be the Commission's primary concern when developing a cost allocation input methodology. In consequence, we have two primary concerns with the Commission's proposed approach: the dismissal of the avoidable cost allocation methodology (ACAM) for allocating costs between regulated and unregulated business units and the lack of certainty as to how common cost efficiency savings arising from mergers will be treated.

(a) ACAM

- 53 We recognise that the potential for 'double counting' costs makes applying ACAM to more than one regulated business problematic. However, this problem does not arise when allocating costs between regulated and unregulated business units.
- 54 The Commission's dismissal of ACAM is based primarily on a desire to share with consumers the efficiencies generated due to economies of scope.¹¹ However, perhaps even more critical is the need to avoid deterring efficient investment. Consumers benefit when incremental efficient investments occur that would not otherwise happen if businesses are unable to retain the resulting economies of scope. The Commission does not seem to take this into account and instead focuses narrowly on ensuring that the price for the regulated service is as low as possible.
- 55 Using any approach other than the ACAM will allocate more than the incremental cost of new investments to unregulated activities. By definition, this deters investment. The Commission considers that its approach of applying FDC/SAC/ABC will not '*unduly deter investment*'.¹² However, it has not defined how much investment it is acceptable to deter in order to achieve lower prices. The Commission should articulate its views on this trade-off.

¹⁰ For a description of the AER criteria see paragraph 5.91 on p110 of the IM paper

¹¹ See e.g. paragraph 5.79 of the IM paper.

¹² See paragraph 5.208 of the IM paper

- 56 The Commission's also appears to have employed an incorrect competitive benchmark in its analysis. It is important to not confuse the effects of fixed and variable common cost savings. Standard economic theory (and the Commission's own framework for analysing mergers) states that it is only *variable* cost savings that are passed through to prices. The Commission's implicit proposition that *fixed* common cost savings would be passed through to consumers in a competitive market¹³ is therefore incorrect.
- 57 It is also puzzling that the Commission argues that FDC/SAC/ABC will better enable comparisons to be made across business units and over time.¹⁴ These approaches are more arbitrary and subjective than ACAM. Indeed, if the primary goal of the allocation methodology was to compare the performance of regulated businesses, ACAM would be a much simpler and more transparent method to use.

(b) Treatment of mergers

- 58 We are encouraged that the Commission has recognised the effect that cost allocation can have on the incentives of firms to undertake efficient mergers. There are currently 29 EDBs, a number viewed by many to be too large. In this regard, The Commission's recognition that double counting common costs may encourage efficient mergers is welcome.¹⁵ However, we are concerned that the proposed approach does not provide sufficient certainty for how these benefits will be treated.
- 59 In paragraph 5.58 the Commission states in relation to the double counting of common costs after a merger that it will "...*treat such situations on a case by case basis*". This provides no certainty to firms as to how any efficiency gains will be treated. The Commission should either describe the process by which these issues will be handled "case by case" or set out a clear methodology that will apply to any merger.
- 60 In designing any methodology it will be important to ensure that firms do not have the incentive to delay mergers due to the timing of the regulatory cycle. If a firm anticipates that a P_0 adjustment will remove the efficiency benefits of a transaction at the beginning of the next regulatory period, it may have an incentive to delay a transaction if it is nearing the end of a regulatory period. Therefore, the period for which merger efficiencies can be realised should be decoupled from the regulatory cycle.

¹³ For example, in paragraph 5.29 of the IM paper the Commission makes no distinction as to whether the efficiencies to be shared relate to fixed or variable costs.

¹⁴ See paragraph 5.72 of the IM paper

¹⁵ See paragraphs 5.56 – 5.58 of the IM paper

- 61 A simple method that the Commission could apply that would provide firms with certainty and also decouple efficiency gains from the pricing period, would be to allow any economies of scope arising from a merger to be retained for a set period (say 10 years). Any common cost efficiencies could then be disclosed separately and deducted from the ROI calculation that is used for comparison with the firm's regulatory WACC to determine current and projected profitability at DPP resets.

CHAPTER 6 - THE REGULATORY ASSET BASE

The opening RAB

(a) Initial value – updated ODV first best method

- 62 As indicated above, arriving at an appropriate opening RAB is critical, since that value is likely to form an important input into any profitability calculation underpinning a P_0 adjustment and, to the extent that it forms a key input into any TFP calculation, it will also influence the annual rate of change in prices. The Commission has made the following preliminary decisions regarding the opening RAB for EDBs:
- 62.1 the opening RAB should be based on the 1 April 2004 ODV estimates, with no adjustments for any 'revaluation gains' accruing prior to 2004; and
 - 62.2 the opening RAB should be rolled forward to 2010 by updating for capital additions, disposals, depreciation and CPI indexation.
- 63 It remains our view that a first best case would involve beginning the new regime with an up-to-date 2010 ODV, with no adjustments for past revaluation gains. As Orion has submitted on a number of past occasions, an up-to-date ODV would reflect the cost that would be faced by a hypothetical new entrant supplanting an incumbent by deploying modern equivalent infrastructure, and is therefore consistent with a contestable market outcome.
- 64 We do not consider that the lack of an up-to-date ODV handbook is a reason for not carrying out an undated 2010 valuation. We consider that the Commission could adopt a principles based handbook, which could have standardised optimisation approaches, standard lives etc, but the actual values could be left to the valuers and auditors to determine. This would require the maximum level of transparency from each EDB in relation to the outcome.

- 65 Should the Commission decide against a new 2010 ODV then, as outlined in our submission on the DPP paper, Orion (reluctantly) accepts the Commission's preference for a 2004 ODV, rolled forward to 2010, subject to the deficiencies associated with that estimate being corrected prior to it being 'locked in'. Indeed, even if the Commission does have a general preference (wrongly in our view) for 'earlier' replacement cost 'base valuations', there can be no justification for blinding itself to any material deficiencies that exist in those valuations.
- 66 We have not set out all of these deficiencies here, since they are addressed extensively in our submission on the DPP paper. However, the RAB should be updated to correct the significant deficiencies associated with that estimate prior to it being 'locked in'. These corrections may include:
- (a) quantity errors (assets omitted or included in error);
 - (b) categorisation errors (assets included but allocated to the incorrect asset category);
 - (c) age errors (assets included but allocated to the incorrect asset base) ;
 - (d) estimation errors (assets where estimates were made about quantity, age, category or location characteristics which are now known to be incorrect;
 - (e) an appropriate allowance for working capital;
 - (f) easements at their replacement cost value; and
 - (g) changes to multipliers
- 67 We also consider that the replacement cost values in the 2004 handbook were incorrect (too low), and that these values are likely to be difficult to correct due to the passage of time. We recommend that the Commission consider other ways to address this issue. One method that would partially assist is to extend the range allowed for multipliers to compensate for the low replacement cost values. However these problems indicate why the use of a 2004 valuation will be a second best substitute for an up-to-date 2010 valuation.
- 68 Additionally, the input methodologies paper also sets out various asset valuation 'principles' with which we have significant concerns. In our view, several are unlikely to promote the purpose of the Act, and may lead to

inappropriately low opening asset values. We take particular issue with the dismissal of the hypothetical new entrant standard, the treatment of easements and the exclusion of working capital from the RAB.

Hypothetical new entrant standard (HNE)

- 69 The Commission appears to dismiss the HNE standard for three reasons, none of which are sound, namely:
- 69.1 the relevant standard is specified by the section 3(1) of the Act: as workable competition;¹⁶
 - 69.2 the concept of contestability does not reflect the reality of regulated markets where there are significant barriers to entry and exit;¹⁷ and
 - 69.3 the HNE standard abstracts away from suppliers past pricing behaviour and so may impose windfall gains.¹⁸
- 70 The first two points have been addressed in detail in our previous submissions,¹⁹ and so will only be summarised here. First, the HNE standard is *consistent* with workable competition rather than being an alternative. Decisions on whether to control and/or how to set prices by reference to an HNE standard – and so an up-to-date ODV valuation – are consistent with the opportunity cost of the resources that would be displaced at that point in time in providing services in the relevant market. The application of regulation using HNE principles therefore seeks to replicate the outcome of a contestable market, despite the fact that actual competition is neither present nor likely. This is entirely consistent with the objective of section 3(1) of the Act.
- 71 Second, when analysing the regulation of markets with monopoly characteristics, any standard of competition will not reflect the reality of the market in question. The purpose of regulation²⁰ is to promote outcomes consistent with workable competition; if the assumptions underlying workable competition reflected the reality of the market in question *it would*

¹⁶ See paragraphs 6.29 and 6.70 of the IM paper.

¹⁷ See paragraph 6.67 of the IM paper.

¹⁸ See paragraph 6.68 of the IM paper.

¹⁹ See, e.g. paragraphs 17-21 of Orion (2009), *Submission on Economic Insights Papers*, 31 July 2009.

²⁰ As encapsulated by the Part 4 purpose statement.

not be regulated. This fundamental point seems to be missed in the Commission's analysis of the HNE standard.

- 72 The third point is slightly different but equally invalid. As we have explained several times previously, there is simply no way of knowing whether 'windfall gains' have occurred over the life of the assets in question because historical returns are unknowable. By allowing recent increases in input costs to drive the selection of the opening RAB the analysis of 'windfall gains' relates to an arbitrary short period that reveals nothing about returns over the life of the assets. Moreover, the argument that past pricing should influence the initial RAB is irrelevant given that the Commission is not legally allowed to 'claw back' excess profits through the choice of the initial RAB.
- 73 In summary, the Commission's dismissal of the HNE standard as a useful reference point for determining the opening RAB (and potentially for moving prices forward over time) is hasty, and reveals a misunderstanding of the fundamental 'notional' value of the principle. Orion considers that it is a key reference point for the derivation of the opening RAB.

Treatment of Easements

- 74 The Commission's position as outlined in the IM paper²¹ is that easements will be assigned either (i) a nil value or (ii) the (un-indexed) historic cost value if records are available.²² We have a number of concerns with this approach:
- 74.1 it is inconsistent with the Commission's approach to other specialised assets;
 - 74.2 it could result in historical expenditure not earning an appropriate return on capital; and
 - 74.3 it may give rise to perverse incentive to dispose of land and is not consistent with the costs that would legitimately be incurred by a new entrant.
- 75 The Commission's general approach in the IM paper towards specialised assets is to use ODRC²³ to set the initial RAB and then roll this value

²¹ See paragraph 6.85-6.90 of the IM paper.

²² See paragraph 6.88 of the IM paper.

²³ More specifically, ODV is used for electricity and gas, although this typically results in ODRC being applied.

forward on an indexed historic cost basis. This contrasts with the proposed approach to easements of using un-indexed historic cost. It is not clear to Orion why easements should be treated any differently to other specialised assets. Our view is that (post the establishment of the initial RAB) *all* specialised assets should be rolled forward on an un-indexed basis, so we consider that the appropriate approach is to value easements at ODRC and then to roll those assets forward on an *un-indexed* basis.

- 76 The Commission's proposal to set the value of easements to zero if historical records are not available is of particular concern. This is inconsistent with the Commission's general approach to asset valuation when there are poor historical records and also risks harming dynamic efficiency by not allowing a return on legitimate expenditure. We note that the absence of accurate historical records has typically led the Commission to favour ODRC for specialised assets²⁴ yet, here, for one particular type of asset the Commission is assigning a value of zero. This approach has the potential to not allow an appropriate return on capital in situations where there was an outlay to acquire the easement, but records of this transaction are unavailable/unreliable.
- 77 Finally, excluding easements would also result in a cost profile that is not consistent with what would occur in a workably competitive market. Easements are a legitimate cost that an averagely efficient entrant would be required to incur, and so should be reflected in the opening RAB at their replacement cost value.

Working capital

- 78 The Commission makes no mention of working capital in its discussion of input methodologies. We consider that a reasonable allowance for working capital should be included in the initial RAB. Working capital is a necessity for all EBDs, since it is an integral part of running an electricity distribution network.
- 79 We recognise that working capital should not be included without limits, since this would create an incentive to over-state working capital. Orion is therefore open to working with the Commission to determine what would be a reasonable allowance of working capital to be included in the RAB.

²⁴ See e.g., Commerce Commission (2008), *Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd: DECISIONS PAPER*, paragraph 246

(b) Roll forward

- 80 The Commission has proposed to roll forward the RAB using CPI, plus capex minus straight-line depreciation and disposals. There are several aspects of the Commission's proposal with which we agree – at least in principle – namely:
- 80.1 We agree that the most pragmatic and straightforward means by which to depreciate the RAB over time is by means of straight-line depreciation.
- 80.2 We also agree that in the context of a customised price path (CPP) any departure from ODV is likely to require the Commission to assess the prudence of capital expenditure – either on an ex-ante or ex-post basis – although:
- (a) the Commission should be mindful of the well-recognised proscription against hindsight in any ex-post prudence review; and
 - (b) the Commission should not look back too far, since it inevitably will be difficult to assess the efficiency of capex from many years ago.
- 80.3 We agree that for the default price path (DPP) the Commission should pay close and careful attention to businesses' asset management plans (AMPs) for the purposes of assessing the ex-ante prudence of capex. In our view, AMPs can provide the ex-ante discipline that is required under the DPP – no other formal mechanism is needed.
- 81 However, we do *not* support the Commission's proposal to use an indexed roll-forward approach (indexed historic cost (IHC)). Rather, we support an un-indexed roll-forward approach (depreciated historic cost approach (DHC)). It is our view that such an approach provides more certainty to EDBs and is therefore more likely to promote the purpose of the Act.
- 82 Provided that the treatment of revaluations and the form of the WACC are chosen to be consistent with the method of indexation, then the *ex ante* NPV of indexation is the same as that for an un-indexed approach. The Commission should therefore be indifferent between the two methods. However, there are practical reasons why an EDB *would not be indifferent* between the two approaches.
- 82.1 An indexed approach involves reduced cash flows in the earlier years of an asset's life, and higher cash flows in the future.

Conversely, an un-indexed approach involves higher cash flows now and lower cash flows in the future. By pushing cash flows further out into the future, an indexed approach exposes EDBs to greater risk than an un-indexed approach. These risks could be of a commercial nature, or could relate to changes in the regulatory rules.

- 82.2 An indexed approach anticipates prices increasing over time. However, if there was a large, unanticipated reduction in future demand (eg, if demand for reticulated electricity declines some time over the next 20 – 30 years and is largely displaced with micro-generation), this would imply rising prices at a time of falling demand, something which is clearly not sustainable. It is this type of risk which may cause EDBs to be more reluctant to invest under an indexed approach. In contrast, an un-indexed approach is more likely to promote investment since capital recovery is less dependent on future demand. Because the approach allows greater up-front recovery, EDBs are less exposed to this risk and thus more likely to invest. In this respect an un-indexed approach is superior in promoting the purpose of the Act.
- 83 We recognise that the new regime is intended to promote regulatory certainty. However, we note that regulatory rules have been unstable and uncertain over recent years and so it will be some time until there is comfort among regulated suppliers that the regime is stable. In the face of regulatory uncertainty it is preferable for EDBs to have a front loaded cashflow profile since they cannot be certain how their revenues, and therefore their ability to recover the costs associated with new investments will be effected in the future. In other words, the objective of regulatory certainty also favours an un-indexed approach.
- 84 Any form of indexation also requires a forecast of the index to be (appropriately) treated as expected revaluation gains for the purposes of pricing. Forecasts can and will differ from outcomes and so indexation exposes EDBs to another source of uncertainty. The requirement to forecast the index also entails additional costs for EDBs, as would any 'wash-up' process in the event that the 'actual' index differs from the 'expected' index.
- 85 In summary, an un-indexed approach is simple, cost effective, compliant with GAAP and is more likely to promote the purpose of the Act than an indexed approach. Ultimately, we favour any valuation methodology that reduces our exposure to regulatory and commercial risks. In terms of the current economic conditions, we consider that an un-indexed approach is likely to best match the cashflows needed to fund the investments that we are likely to be undertaking, so is more likely to provide appropriate

incentives for innovation and investment, consistent with the s52A purpose statement. In consequence, we recommend that the Commission uses a non-indexed roll-forward approach.

- 86 Finally, should the Commission adopt a HC approach then we agree that a roll-forward (historic) cost handbook will need to be developed. We consider that the Handbook should remain 'principles-based' wherever possible, rather than being overly prescriptive. We are concerned that the description of the requirements for a HC handbook²⁵ and the detail required in preparing a HC handbook may be similar to that required to prepare an updated ODV handbook.

CHAPTER 7 - REGULATORY TAXATION

Approaches to regulatory taxation

- 87 The Commission considers that there are three broad options available when setting the input methodology for the calculation of regulatory taxation:
- 87.1 the tax expense approach;
 - 87.2 the deferred tax approach; and
 - 87.3 the tax payable approach.
- 88 Focussing on these three options, there are two levels to this debate. First, does a method that uses regulatory depreciation (e.g. tax expense or deferred tax) better serve the purpose of the Act than a method that uses tax depreciation (e.g. tax payable)? Second, if tax depreciation is found to be preferable, the choice is simple – tax payable. However, if regulatory depreciation is preferable, the Commission must determine which of tax expense and deferred tax better serve the purpose of the Act.

The Commission prefers the tax payable (tax depreciation) approach

- 89 The Commission prefers the tax payable approach, which attempts to model the suppliers' annual tax liabilities to the IRD as a result of supplying regulated services. One benefit of this approach is said to be ensuring that suppliers are fully compensated for tax paid without being able to distort the level of taxation.

²⁵ See paragraphs 6.268 to 6.292 of the IM paper

However tax payable does not achieve the s 52A(1) regulatory objectives

- 90 The treatment of taxation is significant since, “as one of the main building blocks, the approach taken by the Commission to estimate a supplier’s tax costs will affect the way all instruments are administered under the Act.”²⁶ Materially, the treatment of taxation “will affect the size of the regulatory allowance for tax costs included in the price-quality path, and thus the overall return and/or timing of the revenues the business is likely to realise.”²⁷
- 91 The Commission initially identifies two statutory objectives as relevant to the ability of regulated suppliers’ to recover their tax costs attributable to the supply of the regulated service and therefore earn normal returns over the lifetime of their assets:
- 91.1 that suppliers continue to have incentives to invest, consistent with s 52A(1)(a); but
- 91.2 are constrained in their ability to over-recover tax costs, consistent with the objective of limiting the ability of suppliers to extract excessive profits under s 52A(1)(d).
- 92 We agree that these objectives are *equally* relevant to consideration of the appropriate approach to regulatory taxation.
- 93 But the Commission’s preference towards adopting tax payable suggests that it has prioritised the statutory objective of limiting the ability for firms to extract excessive profits over s 52A(1)’s other equally relevant objectives. For example:
- 93.1 the tax payable approach has the effect of treating firms with old assets (with low depreciation, a higher tax expense, and therefore a notionally lower profit on return) differently from firms with new assets or assets for which they essentially paid for goodwill over and above RAB (which will experience high tax depreciation, giving rise to a low tax expense and thus a [notionally higher/artificially inflated] surplus on the same type of asset). The different treatment could give rise to two effects:

²⁶ See paragraph 7.2 of the IM paper.

²⁷ See paragraph 7.3 of the IM paper.

- (a) a firm which pays above RAB for an asset or buys it new will have a lower tax expense, but will be unable to enjoy any real benefit of this since the lower tax expense will simply serve to artificially inflate the firm's notional return, thereby limiting its ability to recover its investment costs and depreciation losses through its pricing since the regulator will have perceived it as making a high profit on return relative to its RAB.²⁸ This effect is likely to disincentivise, or at least create a chilling effect in respect of, making new investments, contrary to the objective in s 52A(1)(a);
- (b) to the extent that this is correct, the tax payable approach could have a detrimental effect on investor confidence since firms with new or above-RAB assets may be perceived as being unable to earn a 'normal' return on their investment. For instance, Firm A who purchased the same asset as Firm B on the same day, but for twice the price may not be able to charge as much as Firm B relative to their respective investment costs;

93.2 the tax payable approach also creates no incentive for firms to seek tax efficiencies since firms are unable to enjoy the benefit of such efficiencies. Removing incentives to achieve tax efficiencies is:

- (a) inconsistent with s 52A(1)(a), since firms will earn no tax efficiencies to apply to investment;
- (b) inconsistent with s 52A(1)(b), since if anything, the tax payable approach creates incentives to maximise tax expenses (rather than achieve tax efficiencies) in order to achieve a notionally lower profit on return, thereby justifying higher pricing to receive a 'normal' return on investment; and
- (c) inconsistent with s 52A(1)(c), since firms will not enjoy any tax efficiency gains to share with consumers (for example, through investment).

94 There is obviously considerable difficulty in applying the regulatory objectives equally where the application of those objectives in the context of taxation conflict. However, to the extent that it is possible, the Commission must strive to do so. This means that the Commission should

²⁸ This has been described by some submitters as giving rise to 'double punishment' – a firm is punished first for paying an above-RAB price for its asset, and second for paying too little tax.

select an approach to taxation that best achieves a middle-ground between the relevant objectives.

- 95 The Commission should not, therefore, select an approach to taxation that biases the objective of constraining the ability of suppliers to extract excessive profits through over-recovering tax costs.²⁹ In doing so, the Commission will fail to give appropriate weight to incentivising investment and improved efficiencies and risks leading itself into regulatory error.
- 96 To this end, Orion submits that an appropriate 'middle-ground' approach is for the benchmark tax depreciation allowance to be derived by reference to the regulatory asset value, ie, a 'regulatory depreciation' approach. Such an approach will:
- 96.1 achieve consistency of treatment across firms irrespective of asset acquisition costs and ownership histories;
 - 96.2 incentivise continued investment;
 - 96.3 incentivise firms to seek tax efficiencies, which can be applied to future investment; and
 - 96.4 better reflects the actual value and lifetimes of the regulated assets.
- 97 Given the constraint on firms' abilities to extract excessive profits in any event, the regulatory depreciation approach is materially more aligned with the objectives set out in s 52A(1) than the tax payable approach.

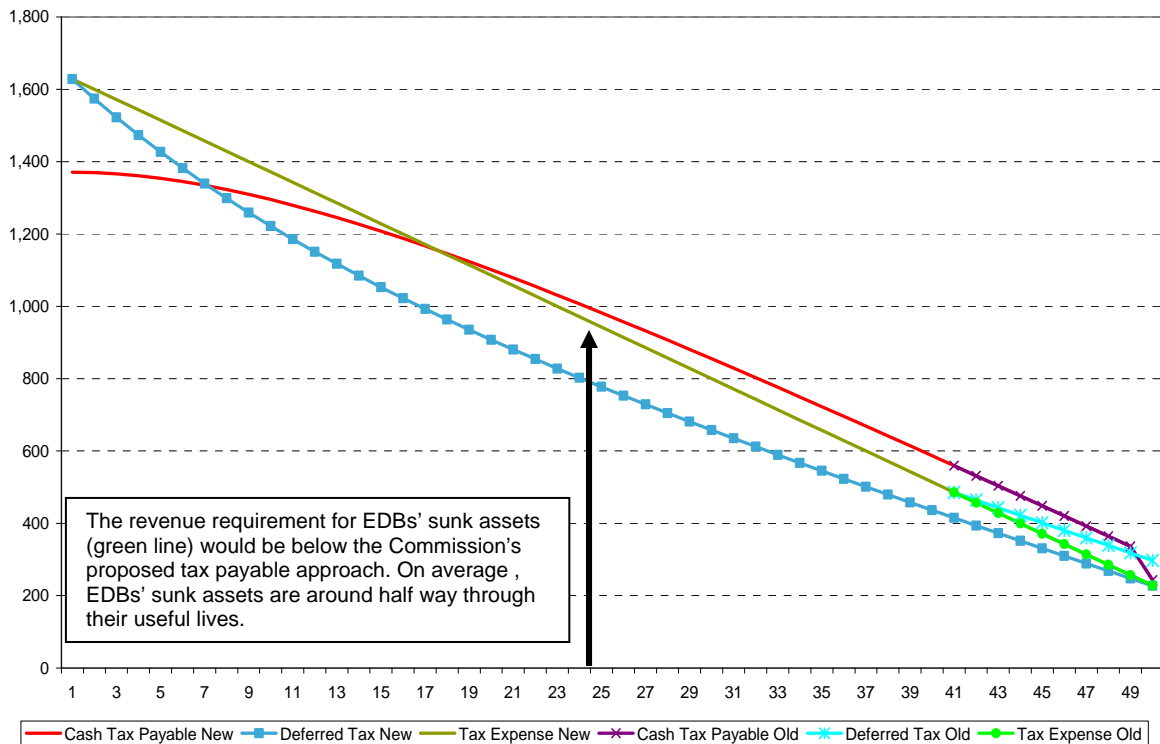
Tax expense or deferred tax

- 98 We think the purpose of the Act will be much better served by an approach which uses regulatory depreciation rather than tax depreciation. Of the two approaches that use the regulatory depreciation, we consider that tax expense is best.
- 99 We are also aware that the ENA has asked PwC to prepare a report comparing the various options proposed by the Commission. We generally endorse this work, and overall we consider that the tax expense approach has a number of advantages:

²⁹ In addition, Orion notes that the Commission's concern in relation to limiting the ability to extract excessive profits is out-dated. Certainly historically, when the market was not regulated, there was a concern that firms were acquiring assets at a high price with the intention of charging consumers high prices. That concern is no longer relevant: in a regulated market, speculative acquisitions are unlikely since there is no prospect of extracting an excessive profit.

- 99.1 it smooths revenues over time
- 99.2 it incentivises investment;
- 99.3 it is simpler to implement and is very transparent;
- 99.4 it exposes the industry to less volatility;
- 99.5 has less risk for EDBs around changing regulation and more certainty for investment; and
- 99.6 in Orion's case, and we believe for many other EDBs, because of our very large sunk assets and their average age, the revenue requirement for a tax payable approach is very close to (in fact just below) tax expense for those sunk assets, as illustrated in Figure 2 below. On this basis alone we would recommend that the Commission should adopt the tax expense approach in order to keep it simple.

Figure 2 Comparison – Tax Methods Applied at Start of Life and with 10 years Remaining Life



CHAPTER 8 - THE REGULATORY COST OF CAPITAL

- 100 There are some aspects of the Commission's draft input methodology on the cost of capital that are welcome. For example, it is encouraging to see that the Commission has given recognition to the widespread consequences of the global financial crisis and is open to considering its effect on parameter estimates.³⁰ We are likewise pleased to see that the Commission is open to providing compensation for real options, ie, 'Type II risks'.³¹
- 101 However, there are several aspects of the Commission's proposal that we consider to be problematic. First, it is not obvious why the Commission has rigidly adopted the Brennan-Lally capital asset pricing model (CAPM) when the majority of its expert panel members recommended something else, ie, either the standard CAPM (Meyers) or a combination of the standard CAPM, international CAPM (ICAPM) and the Brennan Lally CAPM (Franks). In short, the Commission's proposal does not appear to reflect the recommendation of its own expert panel and its reasons for this departure are not clear.
- 102 The Commission's proposed approach to calculating the cost of debt is also problematic. The draft guidelines propose that the cost of debt be calculated by reference to corporate debt with an investment grade rating and a maturity corresponding to the risk free rate. The troublesome aspect of this proposal is that the maturity of the risk free rate is proposed to be set by reference to *the length of the regulatory period*. In other words, if the regulatory period is, say, 3-years then the Commission will use a 3-year risk-free rate and a 3-year corporate bond yield to estimate the debt margin. The use of such a short maturity period increases substantially increases the refinancing risk that a firm bears.
- 103 Put simply, no firm finances its assets on such a short maturity. Recently Australian energy utilities submitted to the Australian Energy Regulator (AER) evidence that firms raising debt generally raise long-term debt, ie, in the order of 10-years. The consequence of the Commission's draft proposal is that it will underestimate the cost of debt for regulated businesses, since the yield on debt is almost always increases over time. Consequently, the Commission should calculate the cost of debt to reflect the borrowing practices of a reasonable business. As noted above, this would involve using a time horizon that extends significantly beyond the length of the regulatory period.

³⁰ See paragraphs 8.132 of the IM paper

³¹ See paragraphs 8.71-8.78 of the IM paper

- 104 Orion also notes that under the framework set out in Section 4.8 of the Revised Draft Cost of Capital Guidelines the Commission does not propose to adopt a mechanistic approach to setting a specific point within the range, eg, the 75th percentile. Rather, it states that ‘the exact movement along the range should be a matter of judgment that should reflect: the degree of uncertainty reflected in the range; the extent to which the final value seems reasonable given the characteristics of the industry; and the prevailing economic conditions’.
- 105 Orion notes that the choice of the 75th percentile is typically used to account for parameter uncertainty and the asymmetric social costs of setting the WACC too low. In consequence, the Commission’s comment at paragraph 8.78 that selecting a point above the mid-point would reduce the effect of any uncompensated asymmetric *private* risks (such as asset stranding and reduced real options) is concerning. These are two different issues and should be accounted for separately.

PRICING METHODOLOGIES (CHAPTERS 9 AND 11)

- 106 Orion notes the combined role of the Commerce commission and Electricity Commission (EC) in developing pricing principles or model approaches. Orion has recently submitted to the EC on its proposed model approach to distribution pricing³². In summary, the EC’s paper proposed the voluntary adoption of a detailed distribution pricing methodology based on a single retail based pricing model (RDM), with the threat of regulation if not adopted by the industry.
- 107 We did not agree with the ECs preferred approach of a RDM. Rather we recommend that:
- 107.1 the EC adopt a set of principles that EDBs should take into account when developing their own pricing methodologies;
 - 107.2 the EC should use the Commerce Commission’s pricing principles³³ as a starting point for developing the set of principles;
 - 107.3 the pricing principles should be consistent with the preliminary views of the Commerce Commission that:

³² <http://www.electricitycommission.govt.nz/pdfs/submissions/pdfstransmission/distribution-pricing/OrionGroup.pdf>

³³ See paragraph 9.63 of the IM paper.

- (a) in relation to the DPP, the costs associated with applying pricing methodologies to the default price-quality paths may outweigh the benefits; and
- (b) in relation to the CPP, that a principles-based approach to pricing methodologies is appropriate for ELBs;

108 We note that the Commission is aware that the EC has commenced a project to develop pricing principles or model approaches for electricity distribution business (the Distribution Pricing project)³⁴. Orion is extremely concerned with the preliminary views set out by the EC in its discussion paper on this issue.

109 The discussion paper details the EC's preliminary thinking on:

109.1 guiding principles to distribution pricing methodology;

109.2 the adoption of a voluntary versus mandatory approach; and

109.3 a single model versus multiple model approach.

110 The thinking expressed in the paper is based to a large extent on the PAWG Report³⁵ and the statements on distribution pricing methodologies set out in the *Government Policy Statement on Electricity Governance* (May 2009) (**GPS**)³⁶.

111 In our view the EC's preliminary thinking:

111.1 has not established what barriers prevent distributors from rationalising legacy pricing methods and innovating;

³⁴ <http://www.electricitycommission.govt.nz/opdev/transmis/distrib-pricing/index.html>

³⁵ "Model approaches to distribution pricing" discussion paper No 2.

³⁶ 100. *The Commission should develop, in consultation with interested parties, principles or model approaches to distribution pricing and monitor their uptake. The Commission should recommend regulations if required to ensure compliance. As part of this work the Commission should investigate barriers to demand side participation.*

101. *The diversity and complexity of the terms and conditions offered by different lines companies for use of their lines is often cited as a significant barrier to expansion of retail competition. The Commission should consider whether standardisation and simplification of tariff schedules and contractual arrangements would facilitate market entry by retailers.*

102. *The Government expects distribution companies to keep any changes to rural line charges in line with changes to urban line charges. The Commission should monitor developments in rural charges.*

111.2 does not take into account the changes that have occurred in the industry since the PAWG report;

111.3 has in any case incorrectly interpreted the PAWG recommendations;

111.4 does not reflect the mandatory nature of input methodologies as they relate to non exempt distribution businesses;

111.5 does not align with the Commerce Commission's preliminary views; and

111.6 will not meet the purpose of Part 4 of the Commerce Act.

112 These points have been addressed in detail in our submissions to the EC on this issue and we refer the Commission to this submission,³⁷ and we summarise them here:

Firstly

112.1 The EC's paper focused on transaction costs as a barrier to retail competition and noted that in the EC's recent market design report retailers overwhelmingly supported standardising network pricing approaches as a means to reduce transaction costs.

112.2 In our view, the transaction costs associated with dealing with multiple distributor pricing arrangements, even when these costs are taken as extreme upper bound estimates, are not significant when compared against the other costs and risks of market entry, and when considered against the possible adverse economic efficiency impacts of standardisation of distribution pricing.

112.3 While we agree that there may be a case for rationalising distribution price structures, we consider that the primary focus of this review should be to establish what barriers prevent distributors from rationalising legacy pricing methods

Secondly

112.4 the industry has moved on significantly since the PAWG report was released. In particular

(a) AMI is being rolled out;

³⁷ <http://www.electricitycommission.govt.nz/opdev/transmis/distrib-pricing/index.html>

- (b) global reconciliation has been implemented;
- (c) the Commerce Act 1998 requires EDBs to be under economic regulatory control, rather than a threshold regime;
- (d) distributed generation regulations and pricing principles have been introduced;
- (e) the Commerce Commission has decided to adopt pricing principles for the gas industry, rather than a detailed prescriptive pricing methodology such as that proposed by PAWG;
- (f) an increasing number of embedded networks exist; and
- (g) real potential exists for electric vehicles to be rolled out in the medium term.

112.5 These significant changes indicate that, rather than adopting the a prescriptive approach to distribution pricing, a less prescriptive, principles-based approach would be more appropriate and in the best long term interests of consumers.

Thirdly

112.6 In our view, the EC has incorrectly interpreted the PAWG findings, particularly with respect to:

- (a) what the wholesale distribution pricing methodology can achieve;
- (b) the optimality of dynamic peak signalling; and
- (c) the actual retail distribution pricing model.

Fourthly

112.7 In our view the EC's preliminary view does not reflect the mandatory nature of input methodologies as they relate to non exempt distribution businesses The Commerce Commission has indicated that.³⁸

³⁸ See paragraphs 11.123 and 11.124 of the IM paper.

Once the Commission is satisfied that the output of the Distribution Pricing Project is appropriate for input methodologies, the Commission will have a number of options for how it takes into account the work of the Electricity Commission in making the relevant input methodology determinations.

For example, although the Electricity Commission's approach will be voluntary (at least initially), the Commission may decide to specify as part of the input methodologies that the Electricity Commission's approach must be applied by the non-exempt businesses in making a customised price-quality proposal.

112.8 Clearly, the above paragraphs indicate a possibility that the Commission's approach may become mandatory for non-exempt businesses. Even if this possibility is remote, we consider that any possibility that the Commerce Commission may effectively mandate the EC's proposed prescriptive single pricing methodology approach should be enough to prevent the EC from taking that prescriptive approach.

112.9 A further concern would be whether a mandatory prescriptive single pricing methodology that applied to the CPP would act as a barrier against EDBs that:

- (a) seek to innovate; and
- (b) require a CPP to facilitate that innovation.

Fifthly

112.10 The EC's preliminary thinking does not reflect the Commerce Commission's preliminary thinking is that:³⁹

Pricing methodologies are relevant for suppliers that are subject to default/customised price-quality regulation or individual price-quality regulation. However, the Commission's current view is that those suppliers that remain on a default price-quality path may not be required to apply the input methodology for pricing methodologies.

- *The Commission considers that there are a number of principles for allocatively efficient pricing applicable to firms with naturally monopolistic characteristics.*

³⁹ IM chapter 9.

The Commission favours a principles-based approach to setting pricing methodologies, with an intermediate level of detail specified in the input methodology. The approach for the Gas Authorisation is an example of an intermediate approach.

- 112.11 The Commerce Commission's proposed principles are significantly different from the EC's proposed principles.

Lastly

- 112.12 The EC's preliminary thinking may not meet the purpose of Part 4 of the Commerce Act . We note that the Commerce Commission states that:

At this stage, the Commission considers it would be unlikely that the Electricity Commission would produce an approach that would be inconsistent with the Commission's statutory provisions. The objectives and desired outcomes for the Electricity Commission—set out in s 172N of the Electricity Act—share a number of common elements with the purpose of Part 4 of the Commerce Act.

Nevertheless, the Electricity Commission does have a broader remit than the Commission ... and this might potentially affect the extent to which the low-level or detailed outcomes of the Distribution Pricing Project are consistent with the purpose of Part 4.

- 112.13 We consider that the prescriptive nature of the Commission's proposed pricing methodology would remove any incentives for EDBs to develop innovative pricing methodologies and products that promote long term benefits for customers as required under section 52A of Part 4.
- 113 We also agree with the concern that the Commerce Commission has raised in relation to potential changes that might be required as result of a prescriptive approach:⁴⁰

The appropriate approach to these matters will be influenced by, among other things, whether any changes to the Electricity Commission's principles or guidelines are anticipated. This is because any change to an input methodology determination must follow the consultation process set out in the Act. The more prescriptive the Electricity Commission's approach is, the more likely a change would need to be made during the seven years

⁴⁰ See paragraph 11.127 of the IM paper.

in which the input methodologies determinations could potentially apply before being reviewed.

114 We consider that the above issues should lead to the Commission to develop, in conjunction with the EC, a set of pricing principles for EDBs to follow rather than implementing a prescriptive approach. Those pricing principles should:

114.1 reflect the principles proposed in the Commerce Commission's gas authorisation decision paper as reproduced in Table 13.5 of the Commerce Commission's input methodologies discussion paper (text reproduced below); or

114.2 reflect the principles outlined in the Commerce Commission's preliminary thinking found in chapter 9 of the input methodologies discussion paper

Table 13.5. Pricing Principles for the Gas Authorisation	
1)	Prices are to signal the economic costs of service provision by: <ul style="list-style-type: none"> a) being subsidy free (equal or greater than incremental costs, and less than or equal to stand alone costs); b) having regard, to the extent practicable, to the level of available service capacity; and c) signalling, to the extent practicable, the impact of additional usage on future investment costs.
2)	Where prices are based on 'efficient' incremental costs would under-recover allowed revenues, the shortfall should be made up by setting prices in a manner that has regard to consumers' demand responsiveness, to the extent practicable.
3)	Provided that prices satisfy (1) above, prices should be responsive to the requirements and circumstances of users in order to: <ul style="list-style-type: none"> a) discourage uneconomic bypass, and b) allow negotiation to better reflect the economic value of specific services.
4)	Development of prices should promote price stability and certainty for customers, and changes to prices should have regard to the impact on customers.

CHAPTER 14 - PROPOSALS FOR CUSTOMISED PRICE PATHS: PROCESS

115 We urge the Commission to ensure the input methodologies for the DPP are sufficiently robust to capture a wide range of EDB circumstances, including what is commonplace (at least in Orion's view) investment in assets and technologies which improve quality and efficiency. If the DPP input methodologies are not robust there is a risk EDBs will be "defaulted" into the CPP process to overcome deficiencies in the DPP. Any

interactions about CPPs will necessarily be high-cost and time consuming – the very things the DPP process is intended to avoid, as is made clear in the Part 4 purpose section.

- 116 The Commission must ensure that low-cost regulation (ie DPP) is available to all EDBs. The Commission should not simply assume an EDB can apply for a CPP to circumvent any difficulties with the DPP. Particularly given the fact that the Commission is not required to consider any more than four proposals for a CPP from EDB's in any one year.
- 117 Orion's position is instructive in that it has invested in extensive undergrounding of wires and in cutting edge technology such as ground fault neutralisers. Both of these investments have been undertaken to improve quality. Yet we do not consider that we should have to apply for a CPP in order to be able to recover such expenditure; rather, any DPP should include appropriate quality incentives, and adequate rates of return to encourage such investment and innovation.
- 118 That said, a CPP may be useful to ensure the Part 4 purposes are achieved in circumstances where the application of the DPP to an EDB might be unsuitable or particularly harsh. With this objective in mind Orion wishes to make the following points about the process of CPP proposal and approval.

Time frames

- 119 The legislation is highly prescriptive as to the time frames and approval process for CPP proposals: there is a 40 working day period to remedy any deficiencies in a proposal, followed by 150 working days in which the Commission must make a determination (as prescribed by s 53T(2)).
- 120 We do not agree with the Commission's tentative view that all CPP proposals be received within a one working week "window". Such an approach might be administratively convenient but does not accord with the scheme and purpose of the Act, nor will it provide sufficient opportunity for EDBs to lodge a proposal. One week simply is too narrow a window – and we doubt such a window is required at all. This is because:
- 120.1 the starting point of the legislation (indeed, the first words of the relevant part of subpart 6) is that a proposal for a CPP is an ongoing option. A CPP proposal may be lodged *at any time* after a DPP is set, subject only to an EDB not being permitted to make a CPP proposal within 12 months of the next DPP reset. We recognise of course s 53Q(2)(b) permits the Commission to specify a date for the

purpose of receiving CPP proposals, but that may be “by” an annual date rather than within a period;

120.2 it is at least conceivable that a business may wish to lodge a CPP proposal outside the window, in which case we do not consider the Commission would be permitted to dismiss such an application out of hand (particularly if it was compliant with the relevant input methodologies and the Commission had not yet received four proposals in that year);

120.3 in any event, one week is too restrictive in the context of a 14 month lead-in for approval and in circumstances where an EDB is permitted to apply for a CPP only once in each regulatory period (s 53Q(3));
and

120.4 the Commission’s broad powers of prioritisation contained in s 53Z permit it to take into account factors such as quality and completeness of proposals; those criteria do not include the order of receipt, which renders a restricted application “window” of little use in determining priority.

121 Orion submits the preferable approach is for the Commission (in line with s 53Q(2)(b)) to nominate an annual date by which CPP proposals must be received for consideration (if possible) in that year, to take effect in the next pricing year. Practices will emerge over time as the Commission and EDBs become aware of the requirements for a CPP proposal – and timeframes can be adjusted as those practices develop. But any attempt in the abstract to limit applicants to a one-week window is not required by the Act and risks rendering a proposal unnecessarily difficult (and cutting across the statutory context described above). There is in any event a practical time limit for any CPP proposal, namely the limit imposed by the arrival of the next pricing year. There does not appear to be a pressing reason to impose a one week “window” at this stage and Orion urges the Commission to leave the point open until such time as the proposal requirements are known and practices emerge.

Completeness

122 We caution the Commission against taking an overly stringent approach in defining “completeness”. This is particularly the case where EDBs only have one opportunity in each regulatory period to apply for a CPP.

123 In our view the Commission should take a broad approach to the completeness of a proposal (and request deficiencies to be remedied if necessary – as is specifically contemplated in the Act) rather than

stringently applying any completeness criterion before a proposal is assessed. Obviously compliance with the s 52T(1)(d) input methodology is required. But the customised nature of CPP proposals means the Commission should not be too hasty in discontinuing proposals (even if s 53S permits it to do so) based on a narrow view of what “completeness” entails.

- 124 We have no qualms about the Commission giving priority to those CPP proposals which are more fully developed and contain complete analysis and reasoning. Indeed “quality and completeness” is the first criterion listed in the statute for prioritising proposals: s 53Z(3)(a). But the gate should not be shut too early on EDBs who may be willing and able at a later stage of the proposal to provide the required information. Orion urges the Commission to use its power to request further information before concluding that a proposal is incomplete and discontinuing it.

CHAPTER 15 - PROPOSALS FOR CUSTOMISED PRICE PATHS: REQUIREMENTS

- 125 Our introductory comments about CPP procedural issues above apply equally to CPP requirements: the Commission should not assume the availability of a CPP is a cure for any deficiencies in the DPP. Ensuring the statutory purpose is met and relatively low-cost regulation is available requires a focus on developing robust input methodologies for the DPP. This will ensure the default path can adequately capture a wide range of EDB scenarios, including those companies (such as Orion) which undertake investment to improve quality and efficiency rather than causing such firms to apply for a customised path because the DPP doesn't capture their investment profile.
- 126 As we have previously submitted, the input methodologies should be furnished with as much detail as possible so as to improve certainty. This applies both in the DPP and CPP contexts.

Need for evaluative criteria

- 127 The Commission must, as far as is reasonably practicable, include in its s 52T(1)(d) determination sufficient detail so that each supplier is reasonably able to estimate the material effects of a CPP on its business: see s 52T(2). EDBs should know exactly what they have to include in a proposal and how that proposal will be assessed (we return to this point below). Such details are required both to make an applicant EDB aware of the requirements for a proposal and to enable it to assess the material effects of its approval (and indeed the likelihood of approval). We note that in addition to the s 53M elements and the list of requirements in s

52T(1)(d) which all CPPs must contain, s 52T(1)(d)(ii) requires the Commission to set out the criteria it will use to evaluate any CPP proposal.

- 128 We welcome the Commission's preliminary view on the requirements of a CPP proposal (set out in chapter 15 of the paper). But without any discussion of the evaluative criteria which will be applied by the Commission it will be difficult – if not impossible – for an EDB to assess with certainty the effects of its CPP proposal (if accepted). A proposal must be considered against clearly defined evaluative criteria – such criteria are central to the meaningful operation of the CPP regime.
- 129 Orion is concerned by the lack of clarity in the IM paper (which is largely a consequence of the lack of clear criteria) about exactly what is being proposed as the CPP requirements. For each of the conceptual elements of a CPP Orion considers the Commission should also set out its preliminary views on how a CPP will be evaluated in terms of that requirement.
- 130 Another cause of uncertainty is the poor drafting of the provisions which set out the Commission's obligations to publish input methodologies and make determinations in relation to the process and content of CPPs. This is because:
- 130.1 section 52T(1)(d) specifies the things which must be in an *input methodology* relating to proposals by businesses for a CPP (including requirements and criteria);
- 130.2 section 53Q(2)(a) refers to the *input methodologies* referred to in s 52T(1)(d) relating to process for and content of CPPs;
- 130.3 but section 54P(1) in describing proposals for CPPs refers to a *s 52P determination* setting out the requirements and criteria for CPP proposals.
- 131 Plainly the legislation cannot require the Commission to issue both an input methodology *and* a s 52P determination covering exactly the same things, namely the requirements and criteria for a CPP proposal. Section 52T(1)(d) does not require a s 52P determination to be made – it simply specifies the things that must be contained in the relevant input methodology. (A CPP is of course *imposed* on an EDB by way of a s 52P determination, but that is once it is approved by the Commission.)
- 132 Because of the mismatch between s 52T(1)(d) and s 54P(1), EDBs are left in the strange position of not being permitted to make a CPP proposal until a s 52P determination on process is made – but there is no requirement in

the legislation for the Commission to make a s 52P determination on process and content of a CPP proposal. And the s 52P determination (if one was made) would have to specify which input methodologies apply – the only ones which would apply would be those about process for, and content of, a CPP proposal. This is circular.

- 133 Orion urges the Commission to seek legislative correction of this error in a timely fashion – otherwise s 54P on its face would bar an EDB from making a CPP proposal, unless the Commission was prepared to issue a s 52P determination which replicated its s 52T(1)(d) input methodologies. That would likely cause confusion and not solve the underlying issue.

Re-opening input methodologies

- 134 Orion does not share the Commission’s firm view that “the availability of a customised price-quality path is not intended to be an opportunity to revisit the input methodologies themselves”. This is plainly incorrect. Rather, s 53Q(2)(a) simply requires that a CPP proposal must comply with the methodologies referred to in s 52T(1)(d), ie the methodologies relating to the process for and content of CPP proposals. Section 53V permits the amendment of an input methodology with the agreement of the relevant EDB.
- 135 The CPP regime enables an EDB to reopen a particular input methodology if it considers its particular circumstances warrant it or if a supplier-specific situation was not contemplated when setting the input methodology. The Commission’s preliminary view that variation of input methodologies should be done “infrequently” is probably correct, but it should not foreclose the possibility entirely.
- 136 The purpose of a CPP to allow an EDB to have an alternative path which meets its particular circumstances must always be kept in mind – and suitability for particular circumstances may well require amendment of the DPP input methodologies. The legislation permits such variation.
- 137 To simply assume that all default input methodologies will apply (and will not be varied) under a CPP risks, in Orion’s view, not addressing the statutory objectives which a customised path was intend to achieve.

Materiality of proposal

- 138 Orion is also concerned at the Commission’s view that “materiality” and “financeability” are criteria for the assessment of a CPP. The source of these concepts is unclear to us. CPPs must comply with the input methodologies specified in s 52T(1)(d) relating to the process for, and

content of, such proposals. But s 52T(1)(d) is silent on “materiality” and “financeability”.

- 139 While such concepts might be useful shorthand for the Commission’s assessment of s 53M factors as maximum prices and revenues, they are only a shorthand. They are not contained in the legislation. (The sole reference to “materiality” is in s 53Z and is in the context of the Commission prioritising proposals.) Orion strongly resists any suggestion that information might be disclosed in order for the Commission to “evaluate” financeability concerns, whatever these might be.
- 140 This is particularly the case where a CPP proposal might not even require assessment of cashflow. A case-by-case approach is, in Orion’s view, preferable, and the Commission should avoid requiring criteria such as financeability to be included in every proposal. For the Commission to include these concepts as requirements when the words do not appear in the Act is, in our view, to risk an error of law and at the least increases the chances of reaching a conclusion as to a CPP which does not accord with the purpose of the Act.

Other issues

- 141 Form of control under a CPP is assumed by the Commission to also be CPI-X, with the possible addition of quality specifications and innovation and incentive mechanisms. It is probably undesirable to view these as “requirements” for inclusion in s 52P determination – rather the appropriate shape of such incentives according to the particular circumstances of an EDB will have to be assessed on a case-by-case basis.

Concluding remarks

- 142 Thank you for the opportunity to make this submission. Orion does not consider that any part of this submission is confidential. If you have any questions please contact: Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely



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