

9 August 2010

Network Performance Branch
Commerce Commission
Wellington

by email: Regulation.Branch@comcom.govt.nz

SUBMISSION ON INPUT METHODOLOGIES: DRAFT DETERMINATION AND REASONS PAPERS FOR ELECTRICITY DISTRIBUTION BUSINESSES

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to make a submission on the Commerce Commission's recently released electricity distribution draft decisions, including the following input methodologies papers and other documents:
 - 1.1 the Commission's draft reasons paper for input methodologies relating to electricity distribution services (the **draft reasons paper**);¹
 - 1.2 the draft input methodologies determination applicable to electricity distribution services (the **draft determination**);²
 - 1.3 the companion paper accompanying the draft determination for input methodologies for electricity distribution businesses and gas pipeline businesses (**companion paper**);³
 - 1.4 the report of the Commission's expert advisers (Professors Yarrow et al) on asset valuation in workably competitive markets (the **Yarrow report**);⁴

¹ Commerce Commission *Input Methodologies (Electricity Distribution Services) Draft Reasons Paper* (June 2010).

² Commerce Commission *Draft Commerce Act (Electricity Distribution Services Input Methodologies) Determination 2010* (2 July 2010).

³ Commerce Commission *Input Methodologies for Electricity Distribution Businesses and Gas Pipelines Businesses: Companion Paper (Draft Determinations and Customised Price Quality Path Requirements)* (2 July 2010).

⁴ Yarrow, Cave, Pollitt and Small *Asset Valuation in Workably Competitive Markets: A Report to the New Zealand Commerce Commission* (May 2010).



- 1.5 the expert reviews of the Commission's draft decisions and reasons for electricity distribution services (the **expert reviews**);
 - 1.6 the recommendation of Franks, Lally and Myers to the Commission on whether to adjust its previous estimate of the tax adjusted market risk premium as a result of the recent global financial crisis (**MRP report**);⁵
 - 1.7 Strata Energy Consulting Ltd's (**Strata**) information requirements overview paper (**Strata overview paper**);⁶ and
 - 1.8 Strata's draft qualitative and quantitative information requirements relating to capital expenditure, operating and maintenance expenditure, and demand (the **draft Strata requirements**).
- 2 The opportunity to comment on electricity distribution draft decisions is an integral element of the consultation process. We thank the Commission for extending the time available for consultation and have structured this submission to reflect the staggered deadlines agreed to by the Commission.

Outline of submission

- 3 Our submission is divided into a number of parts, which will be sequentially filed with the Commission according to the deadlines announced by the Commission in mid-July 2010. We **enclose** the parts of our submission due on 9 August (Parts 1, 2, 3, 4, and 5).
- 4 At the end of the consultation process, Orion intends to provide the Commission a collated version of its submission and appendices as one document.
- 5 Our submission will comprise the following parts:
 - 5.1 **Part 1 - Legal Overview**, on which Orion supports the ENA position;

⁵ Franks, Lally and Myers Recommendation to the New Zealand Commerce Commission on whether or not it should change its previous estimate of the tax adjusted market risk premium as a result of the recent global financial crisis (14 April 2010).

⁶ Strata Energy Consulting Limited Specifying the CPP information requirements relating to capital expenditure, operating and maintenance expenditure, and demand: For the Commerce Commission (30 June 2010).

- 5.2 **Part 2 - Cost Allocation**, an issue on which Orion supports the position of the Electricity Networks Association (the **ENA**) and makes a brief separate submission;
- 5.3 **Part 3 – Regulatory Tax**, on which Orion now supports the ENA submission;
- 5.4 **Part 4 – Pricing Methodologies**, an issue on which Orion supports the ENA submission, and notes its additional comments and concerns in relation to the interface between the newly-created Electricity Authority (**EA**) and the Part 4 regime;
- 5.5 **Part 5 – Regulatory Rules and Processes**, an issue on which Orion supports the ENA submissions, and notes a few additional comments;
- 5.6 **Part 6 – Cost of Capital**, which also covers the Commission’s approach to calculating the market risk premium;
- 5.7 **Part 7 – Asset Valuation**, addressing the correct legal approach to Part 4 and why the workable competition standard requires an up-to-date replacement cost valuation, supported by a separate report from Orion’s expert economic advisers NERA Economic Consulting Limited (**NERA**);
- 5.8 **Part 8 – Customised Price/Quality Paths**; and
- 5.9 **Part 9 – Comments on the Draft Determinations.**

Expert report and other materials

- 6 In addition to this submission Orion has engaged its expert economic advisers, NERA, to respond to various aspects of the Commission’s draft decisions. A report prepared by NERA addressing asset valuation methodologies and workably competitive markets will be attached as an appendix to Part 7.
- 7 Orion’s submissions should be read in conjunction with (and are intended to be complementary to) the submissions filed by the ENA on the draft input methodology decisions (the **ENA submissions**), and the expert reports prepared for the ENA in support of its submissions.

- 8 For the avoidance of doubt, all prior Orion and ENA submissions submitted under Part 4, together with all accompanying expert evidence and referenced documents, form part of the record for the purpose of section 52Z of the Commerce Act 1986.
- 9 Orion is preparing a list of the documents on which it relies and that list (an appendix to our submission) will be filed at the end of the consultation process.
- 10 During the consultation process to date, Orion has referred in its submissions to various additional documents (including submissions) from other regulatory contexts – in particular documents produced by the Commission (and submissions filed by Orion and other industry participants) during the Part 4A thresholds regime from 2004 to 2008. Again, for the avoidance of doubt, we expressly incorporate those additional documents into the record for the input methodologies consultation process, and rely on their content in this process.
- 11 To date we have proceeded on the basis that the Commission has ready access to all of the documents referred to, so we have not attached copies of the documents to this or our earlier submissions. However, we are happy to provide copies to the Commission if needed.
- 12 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

A handwritten signature in black ink, appearing to be 'R. Sutton', written in a cursive style.

Roger Sutton
Chief Executive Officer

PART 1: LEGAL OVERVIEW

Summary of Orion's position

- 1.1 Throughout the input methodologies consultation process Orion has emphasised the central importance of the section 52A purpose statement, and the workably competitive standard, to the integrity of the Part 4 regime. Any input methodology must meet those requirements, and this, in turn, imposes obligations on the Commission when developing the input methodologies. In particular:
 - 1.1.1 the Commission must ensure it selects a methodology which produces an outcome consistent with the outcome seen in workably competitive markets; and
 - 1.1.2 where more than one input methodology is potentially available, the Commission must select the input methodology which is materially better at meeting the section 52A purpose statement than another, alternative, methodology.
- 1.2 We have had the opportunity to review the ENA submission on the legal overview to the input methodologies and the Commission's task in selecting the input methodology which best delivers against the workably competitive standard. We support that submission in its entirety and adopt its conclusions as our own.
- 1.3 We also make the following additional submissions.

Section 52A purpose statement

- 1.4 The purpose statement contained in section 52A is of paramount importance to the Commission's task in developing the input methodologies. As Orion has previously submitted, the primary objective in setting input methodologies is to promote the long-term benefit of consumers by promoting outcomes consistent with those expected in workably competitive markets.
- 1.5 The workably competitive standard is non-negotiable. It is not open to the Commission to adopt an approach to the design of the input methodologies that falls outside the boundaries of that which is workably competitive, even if such an approach is considered to deliver a different and preferred balance of section 52A(1)(a) – (d) factors. Parliament has

signalled that workable competition is the standard that best delivers against the criteria listed in section 52A(1)(a) – (d).

- 1.6 As we have previously submitted,⁷ it would be a mistake to seek to deploy specific regulatory devices with a view to achieving an optimal balance of the section 52A(1)(a) – (d) criteria. Rather, the Commission should use criteria as a checklist to ensure any particular application of the workably competitive standard does not (taken as a whole in the wider context of the regulatory design) somehow generate an outcome which fails completely to address these specific concerns.
- 1.7 We believe that the Commission should assume that the criteria listed at section 52A(1)(a) – (d) are outcomes one would ordinarily expect to see from the proper application of the long-term benefit/workable competition approach. In other words if the workably competitive standard is used as the Commission's starting point, each of the section 52A(1)(a) – (d) criteria flows as a matter of course.

Link between section 52A and workable competition standard

- 1.8 In setting the input methodologies the Commission must always keep in mind the outcomes that would be produced in the long term in a workably competitive market. In developing a particular input methodology, the Commission must consider how the outcomes produced in a workably competitive market can be mimicked (for a regulated EDB) by applying that input IM.
- 1.9 The Commission has at times departed from the workably competitive standard in approaching its task in developing the input methodologies (and in particular in relation to the asset valuation methodology). It has (in our view incorrectly) identified features of the statutory framework, or its assumptions about the results a particular methodology might yield, as supporting one methodology over another. For example:
- 1.9.1 the Commission describes subsections 52A(1)(a) and (d) as the “key” regulatory objectives relevant to setting the initial RAB. The Commission then specifically identifies limb (d) (the need to limit

⁷ Orion New Zealand Limited, *Submission on the Regulatory Provisions of the Commerce Act 1986*, 16 February 2009, at para 9 *et seq.*

suppliers from extracting excessive profits) as a reason **not** to adopt a new 2010 ODV;⁸

1.9.2 the Commission suggests that, because of strong increases in replacement costs in the EDB sector up to 2007, the purpose of Part 4 would be promoted if its input methodology valuation uses earlier valuations where feasible. This base valuation would be updated, the Commission suggested (and has now incorporated in its draft methodology), “in a manner consistent with suppliers’ actual pricing behaviour”. This will, the Commission contends, minimise “windfall” gains or losses;⁹

1.9.3 a related issue is that the Commission’s assumption that a 2010 ODV will give rise to rate shock for consumers appears to be a critical reason for using the 2009 disclosed values. But there is not any way of knowing whether 2010 will result in rate shock, because the analysis has not yet been done (and, in any event, RAB is only one determinant of EDBs’ prices).

1.10 These approaches highlight the need to ensure the workably competitive standard is kept front and centre when assessing a potential input methodology. It is incorrect for the Commission to identify certain of the section 52A(1)(a) – (d) criteria as a reason to opt for a different input methodology. It is also impermissible for the Commission to identify supposed consequences of particular methodologies as “windfall” gains – by definition, an input methodology which meets the section 52A standard (and is sufficiently accurate) will deliver an appropriate value. Whether that notional value is higher (or lower) than the status quo is not relevant to the Commission’s assessment of whether the draft methodology is fit for purpose.

1.11 The Commission’s reasoning in this regard has resulted in various draft input methodologies (in particular, its proposed approach to asset valuation) which do not appropriately mimic the outcomes seen in workably competitive markets and thus do not meet the section 52A purpose statement.

⁸ Draft reasons paper, at para 4.3.16.

⁹ IM discussion paper, at para 6.73 *et seq.*

PART 2: COST ALLOCATION

- 2.1 Orion is not involved in any regulated activities other than the provision of electricity distribution services, has extremely limited involvement in the day-to-day control of other companies engaged in unregulated activities (at least at present) and does not have any internal operating divisions engaged in unregulated activities on a significant scale. For these reasons, we do not consider that our unregulated activities are sufficiently material to justify mandatory compliance with a cost allocation methodology.¹⁰
- 2.2 Our principal concern is therefore to ensure that the Commission does not force us to expend needless time and expense complying with a cost allocation methodology that delivers little or no benefit to anyone. Devoting resources to developing and applying a set of allocation rules for costs that are not material is neither justified nor desirable, particularly in light of the statutory requirement that any input methodology must not unduly deter investment and innovation (see section 52T(3)).
- 2.3 For these reasons we are prepared to support (and have previously supported¹¹) the Commission's proposed flexible approach to cost allocation whereby businesses are able to adopt cost allocators that are the most suitable in their own particular circumstances. We are also prepared to support the introduction of cost allocation methodology screening criteria (**CAMSC**). However, that support is conditional on a threshold defined in such a way that unregulated activities that are peripheral to core regulated activities are not captured.
- 2.4 In our opinion the CAMSC described in the Commission's draft decision are not presently designed in such a way that appropriately limits the reach of the methodology. We have had the opportunity to review the modifications to the CAMSC recommended by the ENA, and consider that they represent material improvements upon the Commission's proposal.

¹⁰ We explained in our pre-workshop submission on the Commission's Emerging Views Paper that, even when we owned and operated gas networks in the North Island, our experience was that relatively few costs were truly 'common' between the businesses. Most components of expenditure were directly attributable to each business, including depreciation, direct maintenance, direct operating costs and the cost of capital. Those common costs that did exist (eg, corporate overheads, IT system costs) amounted to a relatively minor percentage (less than 5 per cent) of overall expenditure. See Orion, *Pre-Workshop Submission on Emerging Views*, 3 February 2010, at para 45.

¹¹ See Orion, *Pre-Workshop Submission on Emerging Views*, 3 February 2010, at para 46.

- 2.5 In particular, we support:
- 2.5.1 increasing the revenue threshold in the CAMSC to **20 per cent**; and
 - 2.5.2 excluding unregulated business units from the cost allocation process if they contribute less than **10 per cent** of total gross profit.
- 2.6 We consider that these modifications are required to ensure that allocations are not mandatory where the compliance costs associated with departing from the avoidable cost allocation methodology (**ACAM**) outweigh the potential effect on regulated prices.
- 2.7 We have also reviewed the other changes that the ENA has proposed to the input methodology and consider that these would also deliver material improvements upon the Commission's proposal that will better meet the purpose of Part 4.

PART 3: REGULATORY TAX

- 3.1 Orion has previously supported¹² a tax expense approach to regulatory taxation. We identified a tax expense approach as appropriate because it allowed for the use of regulatory depreciation, and also because it is simpler to implement and smoothes revenues over time. In its draft reasons paper, however, the Commission has adopted a deferred tax approach. This approach is also preferred by the majority of EDBs.
- 3.2 In view of this overall support we are prepared to support the Commission's draft decision to estimate an EDB's tax obligations using the deferred tax approach subject to the changes proposed by the ENA.
- 3.3 We have had the opportunity to review the submission on regulatory tax prepared by the ENA, along with PricewaterhouseCoopers' accompanying report, and we support that submission in its entirety and adopt its conclusions as our own.

¹² See Orion New Zealand Limited, *Submission on Input Methodologies*, 14 August 2009, at para 99.

PART 4: PRICING METHODOLOGIES

Summary

- 4.1 Throughout the input methodology consultation process, Orion has consistently supported the introduction of high-level principles to guide the determination of prices. We believe that such an approach will give a useful steer to businesses, whilst permitting discretion to structure their pricing so as to best give effect to those principles.¹³
- 4.2 We continue to support a 'principles-based' approach to pricing as the best way to meet the requirements of the purpose statement. As the Commission is also no doubt aware, we have made an equivalent recommendation to the Electricity Commission (**EC**), soon to become the Electricity Authority (**EA**), in the context of its distribution pricing consultation.
- 4.3 We consequently support:
- 4.3.1 the Commission's draft decision to adopt an input methodology for pricing methodologies that specifies high-level principles intended to facilitate efficient pricing; and
 - 4.3.2 the Commission's draft pricing principles, particularly to the extent those draft principles are consistent with the EC distribution pricing principles.
- 4.4 Despite these meritorious aspects of the draft decision, we consider that there is still significant work to be done before the Commission has discharged its responsibilities under the Act.
- 4.5 We have had the opportunity to review the submission on pricing methodologies prepared by the ENA and endorse those views. Below we elaborate on some matters of particular concern to Orion.

Insufficient information

- 4.6 There are a number of important matters that the Commission has provided little or no attention to in its draft decision. This is unsatisfactory. The most troubling omission is the complete absence of any explanation of

¹³ See Orion New Zealand Limited, *Submission on the Input Methodologies* 14 August 2009, at para 106.

how the Commission intends to undertake P_0 adjustments when it resets the DPP (assuming that it concludes that such adjustments are needed).

- 4.7 Although Orion supported the decision to defer any such adjustments until the relevant input methodologies had been determined, this does not obviate the Commission's responsibility to articulate in an input methodology (the rules and processes methodologies being the obvious candidate) the methodology that it will employ.¹⁴ Without knowing which input methodologies are relevant to the reset process (and how those inputs will inform the Commission's assessment of an EDB's 'current and projected profitability') an EDB cannot reasonably estimate the effects of the draft input methodologies on its business.
- 4.8 The Commission has signalled it is not prepared to set the mechanism for the P_0 reset as an input methodology. In Orion's view the statutory obligations in section 52T(2) nevertheless require it to explain *how* it will incorporate the draft methodologies into that reset process - and it has not done so in the draft determination.

Information required

- 4.9 A further area of uncertainty is the extent of information that the Commission will require an EDB to provide so as to *demonstrate consistency* with the pricing principles.¹⁵ Orion, and we suppose most EDBs, will be having regard to and assessing alignment with the EC pricing principles as we develop pricing from 1 April 2011. The EC process (which we must presume will be taken over by the EA) anticipates EDBs reporting on alignment with the principles (by March 2011), and a further independent assessment of that alignment (by March 2012).
- 4.10 We recommend that EDBs' published pricing methodologies and associated reporting against the principles under the EC regime be taken as appropriate disclosure for the purposes of information disclosure under Part 4. The independent assessments will then be further information available to the Commission. We judge this to be an economical approach which not only recognises both regulators' interest in the area, but which also avoids any undue compliance burden for EDBs.

CPP pricing

¹⁴ See Part 4 of our submission relating to rules and processes for a full discussion of this issue.

¹⁵ See draft determination, section 2.6.1(a) on p 35.

- 4.11 If an EDB applies for a CPP the Commission may amend the EDB's pricing methodology (or substitute its own methodology)¹⁶ if it considers the amended or substituted methodology would better meet the purpose of Part 4.¹⁷ Such substitution may have material consequences for an EDB, and so it is concerning that the Commission has provided so little detail about the circumstances in which it will exercise its discretion. In principle, there is nothing to prevent the Commission from requiring *annual* amendments.¹⁸ This is unsatisfactory.
- 4.12 Orion does not consider that an approach which permits "re-opening" of pricing is in accordance with the Commission's obligation to select a methodology which promotes certainty for suppliers and consumers of regulated services (in accordance with section 52R). In our view, such amendments should be applied sparingly. Moreover, if an EDB's pricing methodology complies with the high-level principles there should be no need for the Commission to contemplate adjustments. In our view, it would be preferable for the pricing methodology to be approved initially as a component of the CPP (and thus be *prima facie* compliant with the pricing principles) rather than being continually subject to re-opening.

Commission's section 54Q obligations

- 4.13 As we have previously submitted:¹⁹

Section 54Q is a clear direction to the Commission to promote incentives for suppliers of electricity lines services to invest in energy efficiency and demand side management and to reduce energy losses. In relation to demand side management Orion considers that the Commission will achieve its 54Q objective in relation to demand side management and losses if it maintains a principles based approach to pricing methodologies as suggested in the DPP paper.

- 4.14 This view reflects a position that demand side management and consideration of losses (at least the technical losses that are within the control of the EDB) are part of the natural business of an EDB. Our

¹⁶ Although it is unclear what the Commission will do after the EA as industry regulator takes over the responsibility for setting pricing methodologies.

¹⁷ See draft determination, section 5.4.1.

¹⁸ See draft determination, section 5.4.2(2).

¹⁹ Orion New Zealand Limited, *Submission on the Regulatory Provisions of the Commerce Act*, 15 April 2009 at para 31.

position is also consistent with well-understood concepts of network economics and seems to align with the pricing principles. We are not sure that it is possible to include a workable incentive scheme in relation to energy efficiency within the DPP, as EDBs are not in the business of buying and selling energy. We note, however, that the ENA submission proposes a possible mechanism for the Commission's consideration.

Relationship with EA pricing methodologies

4.15 The Commission's jurisdiction to set pricing methodologies will soon be transferred to the EA when the *Electricity Industry Bill (EIB)* passes into law (very likely to occur in the next two months). This transfer of jurisdiction raises considerable uncertainty for EDBs in relation to the pricing methodology to apply to the DPP and to CPPs, for the following reasons:

4.15.1 Once the power to set pricing methodologies is transferred to the EA (which will set pricing methodologies as part of the Electricity Industry Participation Code (**Code**)), an EDB will be obliged to comply with the EA's pricing methodologies. It is possible the EA may set pricing methodologies which do not comply with the requirements of Part 4 (or otherwise conflict with the pricing principles set out by the Commission in its draft information disclosure methodology).

4.15.2 There is also the risk that the EA might impose a 'standardised' pricing methodology which requires an EDB to make significant and costly changes to its business systems and procedures.²⁰ This expenditure may not be recoverable under the DPP if such a change occurs in the middle of a regulatory period. This highlights further the need to ensure consistency between the two regulatory regimes.

4.15.3 The EIB transfers jurisdiction to the EA for setting pricing methodologies, but it is possible that the Commission may act inconsistently with the Code when exercising other powers under the Commerce Act which may relate to or affect EDBs' pricing (for example, a decision to approve a particular CPP). Although the Commission is obliged to have regard to the Code before exercising its powers under the Commerce Act 1986, it is not

²⁰ The EIB expressly refers to 'more standardised' tariff structures for EDBs.

prevented from exercising powers which may (indirectly) relate to or affect pricing methodologies.

- 4.15.4 As Orion noted in its submission to the select committee on the EIB, inconsistencies between the two regulatory regimes may lead to an EDB being unable to recover all its costs or result in price shocks for a particular group of customers,²¹ and it is also conceivable that EDBs may end up in the uncomfortable position of having to comply with two conflicting pricing methodologies.
- 4.16 The Commission must ensure that the integrity of Part 4 is not undermined by any pricing methodology set by the EA (once the EIB comes into force), be it by inconsistency between the regimes or the two regulators (directly or indirectly) imposing differing requirements. For this reason we believe the Commission should in its initial final determination address each of the uncertainties identified in para 4.15.

²¹ Orion New Zealand Limited, *Submission to the Finance and Expenditure Select Committee on the Electricity Industry Bill*, 17 March 2010.

PART 5: RULES AND PROCESSES

Orion's position

- 5.1 Orion supports a number of aspects of the Commission's draft decisions in relation to regulatory rules and processes, including:
 - 5.1.1 the retention of a weighted average price cap, which ensures EDBs retain flexibility around pricing methodologies;
 - 5.1.2 the restriction on the circumstances in which the DPP will be re-opened (subject to our comments below);
 - 5.1.3 the recognition that EDBs must have the ability to recover material costs arising from events that are uncontrollable and unforeseen (subject again to our comments below in relation to the definition and treatment of pass-through costs); and
 - 5.1.4 the introduction of an incremental rolling incentive scheme (**IRIS**), particularly if the improvements suggested by the ENA are implemented.
- 5.2 However, several facets of the draft input methodology require significant further work before it is fit for purpose, most notably:
 - 5.2.1 the Commission must articulate the way in which it will undertake any P_0 reset;
 - 5.2.2 clarification is needed as to whether related services (such as load management and capital contributions) are included in the definition of 'electricity distribution service';
 - 5.2.3 ;the identification and treatment of pass-through costs and 'recoverable costs', particularly avoided transmission charges; and
 - 5.2.4 enforcement guidelines are needed, particularly in relation to breaches of the price-path that are minor or inadvertent.
- 5.3 We address these matters in more detail below. Orion has also had the opportunity to review the draft submission prepared by the ENA. We support that submission in its entirety and adopt its conclusions as our own.

P₀ reset methodology

- 5.4 Orion has previously supported delaying any starting price adjustment until after the relevant IMs have been finalised.²² Attempting such an exercise without the necessary components in place (for example, a cost of capital IM, an asset valuation IM, etc) strikes us as counterintuitive.
- 5.5 However, as Orion explained in the part of this submission relating to pricing methodologies, that does not obviate the Commission's responsibility to explain *how* it will undertake a P₀ reset.²³ Its failure to do so in its draft reasons paper restricts our ability to respond in a meaningful way on IMs such as the cost of capital and asset valuation because we *do not know* how the Commission will ultimately use those IMs to set starting prices. Specifically, we cannot:
- 5.5.1 reasonably estimate the material effects of key IMs on our business;
or
 - 5.5.2 determine the steps that we will need to take to show that our ROI is within the range permitted by the DPP.
- 5.6 As the Commission has acknowledged, some IMs will be 'relevant to the calculation of allowed revenue',²⁴ while others will not. In its draft determination the Commission refers to 'its assessment of appropriate adjustment to [starting prices]' which will presumably rely on certain IMs.²⁵ However, the Commission has not set out any details of which IMs are relevant to that assessment and in what manner. Simply listing the potentially relevant IMs without explaining *how* they will be harnessed in any price reset provides no meaningful guidance to businesses and is entirely unsatisfactory.
- 5.7 The Commission has failed to specify in any input methodology (as a component of the 'rules and processes' IM) how any P₀ reset will take effect. The Commission's approach is inconsistent with the requirements of Part 4. In particular, until information about the P₀ reset process is provided then the Commission has not complied with the requirements of

²² See, eg, Orion New Zealand Limited, *Submission on Initial Reset of DPP – Draft Decisions Paper 12* October 2009 at p 17; *Submission on Reset of DPP for EDBs* 17 July 2009 at p 13.

²³ See Part 3 of this submission on pricing methodologies.

²⁴ See, eg, draft reasons paper, at para 7.1.2.

²⁵ See draft determination, clause 4.1.9.

section 52T(2) insofar as EDBs are not able to estimate the effects of the draft input methodologies. This has compromised the current phase of consultation process. We support the letter of the ENA to the Commission dated 23 July 2010 requesting the Commission to release information about the P₀ reset process as part of its IM (and specifying the P₀ reset as an IM).²⁶

Relationship with information disclosure

- 5.8 Orion is concerned about the lack of clarity in the draft determination regarding the relationship between information disclosure and the DPP. The Commission must set out in more detail the interface between the two types of regulation. As we explain below, some input methodologies are common to the two regimes, but others are not. Additionally, and as Orion has submitted previously, we consider that information disclosure requirements should be considerably simplified given that EDBs are now under direct control.²⁷
- 5.9 We are unsure on what basis particular components were chosen for the information disclosure IM. For example, cost allocation, asset valuation and cost of capital (subparts 2, 3 and 5 respectively) are specified in the Information Disclosure IM, but are not obviously required at all under a DPP. They might be required (along with other inputs) for a P₀ reset, but being fit for that purpose may or may not coincide with the (essentially comparative) objectives of information disclosure. In any case the values delivered by those inputs will presumably not need to be disclosed each year, since resets are not annual occurrences.
- 5.10 To the extent that actual information disclosure will include such matters as, for example, asset valuation, we would have thought that it would be more sensible to set out the way asset valuations are to be done in an Asset Valuation IM, and then refer to that, if relevant, in an Information Disclosure determination, or indeed any other determination where asset valuation is relevant.

²⁶ We further note that the Commission has discretion to determine the P₀ reset as an input methodology if it sees fit. Section 52T refers to matters which the input methodologies "must include": this wording is non-exhaustive and contemplates other input methodologies (not on the list contained in section 52T(1)) being determined as required. The Commission itself takes the view it has significant flexibility to determine any input methodology it thinks appropriate: '[the Commission] may set an IM on any matter'. See draft reasons paper, at para 8.1.2.

²⁷ Orion New Zealand Limited, *Submission on Information Disclosure*, 11 September 2009, at para 8.

- 5.11 In this regard we note there are separate methodologies for the estimation of the cost of capital applicable to EDBs under information disclosure and under the DPP. The two methodologies are subtly different.²⁸ The Commission has previously indicated the cost of capital is only relevant under information disclosure for comparative purposes,²⁹ although it is not immediately apparent why the two methodologies are different.
- 5.12 In Orion's view the appropriate starting point is to ensure consistency across all input methodologies with which an EDB must comply. There should be *one* methodology for cost of capital, unless there are strong reasons to promulgate a separate, different methodology for a particular type of regulation applicable to EDBs.
- 5.13 Orion notes that, while the Commission has indicated a number of input methodologies that will apply to information disclosure, it has failed to provide the necessary rules and processes to indicate what the actual disclosure requirements will be. We note in this regard that:
- 5.13.1 the Strata papers setting out the draft CPP information requirements indicate the level of detail required for an EDB to assess the information required for compliance (and consistency here is particularly relevant if the electricity information disclosure requirements (**IDRs**) are used to inform the development of the draft CPP requirements, as Strata has suggested); but
- 5.13.2 as Orion has previously submitted, the information disclosure requirements applicable to the DPP should be considerably reduced and simplified. This step, if undertaken, would reduce the level of detail compared to the CPP requirements.

Format of information for CPP proposal

- 5.14 We also submit the information required from an individual EDB when applying for a customised price path (**CPP**) should be in the format dictated by that EDB's standard business operations. Compliance with Schedule C of the draft determination is onerous and will not materially increase the quality of information provided to the Commission.

²⁸ In particular, we note the WACC methodology for the DPP does not incorporate a concept of 'post-tax WACC' and requires disclosure in September; *cf*, the information disclosure WACC methodology which refers to a 'WACC range' and a method for estimating the mid-point of the range, and requires disclosure in April.

²⁹ IM discussion paper, 19 June 2009, at para 4.58.

- 5.15 This is because the categories in Schedule C (like the existing information disclosure requirements) will not necessarily match the way that individual companies manage and report their projects. The reappportionment for regulatory purposes is therefore an additional step which may provide a basis for intercompany comparisons, but certainly adds considerable complexity. Comparability is a less important objective in the CPP context than for other EDBs subject to the DPP. Standardisation also provides little or no utility in the CPP context – Orion’s experience is that the additional breakdown of our management information to match the Commission’s disclosure categories is onerous and provides no benefit, except to achieve regulatory compliance.
- 5.16 For these reasons Orion submits the draft determination should be amended to permit an applicant company to provide data which reflects the way that the company manages its assets and projects.

Recoverable costs

- 5.17 Orion acknowledges the Commission’s decision to adopt a new category of ‘recoverable costs’. We have submitted previously that EDBs must have the ability to recover material costs arising from events that are uncontrollable and unforeseen. The definition of ‘recoverable cost’ appears to encompass such circumstances, which is a positive development. However, the Commission appears to have retained for itself an unfettered discretion to decide:

5.17.1 when a cost is ‘recoverable’ and when it is not; and

5.17.2 when less than 100 per cent of a recoverable cost will be eligible for pass-through; and

5.17.3 whether to approve new investment contracts with Transpower and avoided transmission arrangements as set out in clause 3.2.4(2)(a).

- 5.18 This is inappropriate. The best approach would be to collapse the distinction between ‘pass-through’ costs and ‘recoverable’ costs (which is needlessly duplicative) and to define the former more broadly. In our view, pass-through costs should be defined so as to include costs:

5.18.1 that are unforeseen and outside the control of the supplier; and

5.18.2 that have not otherwise been recovered under a DPP or were not included in the derivation of a CPP.

- 5.19 There should be a strong presumption that 100 per cent of such costs should be passed through. The Commission should also clearly specify those circumstances in which that presumption *may be rebutted*, and less than 100 per cent of the relevant cost passed through. It is yet to do so. This will provide much-needed certainty to EDBs.
- 5.20 The Commission should also specify the process by which it may decide *not to approve* new investment contracts (**NIC**) and avoided transmission arrangements under clause 3.2.4(2)(a). Overall, we are concerned that the Commission requirement to approve NICs anticipates a level of involvement by the Commission in an EDB's business which is not appropriate under a low cost DPP. We are also concerned that the proposed draft determination does not include the avoidance of an NIC as an avoided transmission charge.
- 5.21 The above issues need addressing to provide much-needed certainty to EDBs.
- 5.22 A key advantage of our proposed approach is the fact it is likely to limit the circumstances in which an EDB might otherwise wish to *re-open* the DPP. Because the definition is non-exhaustive, this means that unforeseen and uncontrollable events (such as extreme weather or terrorist incidents) could be dealt with expeditiously through a well-defined, constrained process that does not require revisiting of all of the parameters underpinning the price path. DPP re-openers can then be confined to events that have broader impacts.
- 5.23 If the Commission chooses to retain a separate category of 'recoverable costs', it must still set out clear criteria describing when a cost will be considered to be 'recoverable' and when less than 100 per cent of such costs will be eligible for pass-through. In this regard, we suggest adopting the criteria described in paragraph 5.18 above. This serves to further illustrate why maintaining a distinction between pass-through and recoverable costs adds a needless layer of complexity.

Criteria for prudency reviews

- 5.24 Orion has similar concerns in regards to possible prudency reviews of new investment.³⁰ As similar point was raised by the Commission in the IM

³⁰ Draft reasons paper, at para 4.4.101.

discussion paper.³¹ The Commission has yet given no detail on the criteria applicable to that review in assessing whether an acquisition is “prudent”. This creates needless uncertainty as Orion and other EDBs are unable to assess the potential effects of any prudency assessment mechanism which may be incorporated in the determination.

Purchase of transmission spur assets

- 5.25 While the Commission is to be congratulated on developing an approach to avoided transmission charges that seeks to address the acquisition of Transpower assets by an EDB, the introduction of an approval process clearly raises the possibility that such investments may not be recoverable. For example, Orion is currently contemplating the purchase of a Transpower spur asset which, if undertaken, will require significant capital expenditure but will result in materially lower transmission charges. Such an investment appears within the spirit of the new recoverable costs definition, but further detail is required on this point to give certainty before such expenditure is undertaken.
- 5.26 As Orion and other EDBs indicated in their letter to the Commission dated 27 July 2010, several key issues relating to an EDB's purchase of spur assets from Transpower remain unresolved in the draft determination. Those issues include:
- 5.26.1 whether the ‘recoverable cost’ (being the avoided transmission charge) is the costs incurred by Transpower to maintain, operate, and make a reasonable return on those assets, or the amount payable by the EDB under the transmission pricing methodology (TPM) (which may not correspond to Transpower's costs);
 - 5.26.2 whether the purchased asset is added to the RAB at the date of purchase, and on this issue we endorse the ENA's submission that the assets are transferred into an EDB's RAB on the transaction date;
 - 5.26.3 whether forecast increases or decreases in the level of the TPM (otherwise payable by the EDB) over the five-year period may be taken into account in assessing the level of recoverable cost;

³¹ IM discussion paper, at paras 6.178 and 6.200.

- 5.26.4 whether a five-year period is in any case appropriate. (We envisage that as an alternative the EDB and the Commission might agree a different term, depending on the specifics of the transaction.);
- 5.26.5 the lack of detail regarding the what information will be required as supporting evidence; and.
- 5.26.6 whether these sorts of transactions deserve their own specific treatment within the pass-through cost / recoverable cost section of the determination.
- 5.27 As the Commission is aware, Orion and other EDBs are in the advanced stages of discussing spur asset purchases with Transpower. The issues above should in our view be addressed in the draft determination as a matter of urgency, on a basis which enables the application of the methodologies to purchases undertaken before 1 April 2011.

Avoided transmission charges

- 5.28 The recoverable cost section also changes the Commission's proposed treatment of other components of avoided transmission charges, and in particular those reductions associated with distributed generation. Clause 3.2.4(5) defines avoided transmission as "an amount of a charge described in (1)(b) payable to Transpower that the Commission is satisfied an EDB has avoided liability to pay as a result of reducing the overall cost of supply of electricity lines services". EDBs are required (under the distributed generation regulations) to pay to consumers any benefit the EDB receives in relation to transmission cost reduction.
- 5.29 Orion's practice to date has been to derive a price for this, estimate the payments to be made, and include those estimates as avoided transmission costs when setting transmission prices. We take a similar approach where we incur cost in building assets that are substitutes for transmission assets. We consider that our approach is consistent with the current definition of avoided transmission which is that:

*avoided transmission charge means, in relation to a distribution business, any **expense** (including the cost of capital) of the distribution business that arises from any generation or other activity*

which substitutes for use of the transmission system³² (emphasis added)

- 5.30 The Commission's new definition would require us to change our approach. This has the following implications:
- 5.30.1 Because of the need to estimate when setting prices, there is no guaranteed relationship between the payments we make to consumers and the actual cost savings achieved.
- 5.30.2 Where we do not (or cannot) demonstrate the savings, the Commission might not retrospectively "approve" it.
- 5.30.3 Where we have discretion over whether we incur the cost (which we do not with respect to distributed generation), the most obvious way to manage the risk is not to incur it.
- 5.31 We urge the Commission to consider maintaining the existing definition of avoided transmission charges quoted in 5.29 above, but note:
- 5.31.1 the observation in 5.20 above that avoided transmission needs to encompass the avoidance of costs that *would have been* associated with an avoided NIC; and
- 5.31.2 the suggestion in 5.26.6 that proposals to acquire transmission assets merit specific treatment.
- 5.32 As also noted in paragraph 5.20 above, there is uncertainty around the nature of the approval process for avoided transmission charges. The process should be amended to acknowledge that EDBs *must* make payments under the distributed generation regulations, and that there is an inevitable lag between when prices are set and when any savings can be calculated.

Enforcement guidelines

- 5.33 The Commission is yet to provide any indication of the circumstances in which it will bring proceedings in respect of a DPP breach.³³ In our view, a

³² From *Commerce Act (Electricity Distribution Thresholds) Notice 2004* made pursuant to Part 4A of the Commerce Act 1986, which continues to apply under the Commerce Act (Electricity Distribution Threshold) Amendment Notice 2009.

set of enforcement guidelines should be developed as a priority, particularly given the prospect of pecuniary penalties for individuals and corporations (in effect a quasi-criminal law process) under the new legislation. Given the potential consequences, EDBs need to know when a breach of a price-quality path will be treated by the Commission as inadvertent or *de minimis*, and when there is a cause for concern.³⁴

- 5.34 A related issue (as described above) is the absence of detail in the draft determination about the level of information and detail that EDBs will need to provide so as to reasonably demonstrate compliance with the DPP. In our view, there is a need for the Commission to consult with industry regarding the scope of information required to demonstrate compliance with a price-quality path. That process has not taken place to date.

³³ Commerce Commission, *Reset of the DPP for EDBs – Discussion Paper*, 19 June 2009, at para X21; and see also the draft reasons paper, at para 8.6.18. We also noted this issue in our submission on the DPP reset process paper: Orion New Zealand Limited, *Submission on the Reset of the DPP for EDBs (Process Paper)*, 19 March 2010, at para 8.

³⁴ Orion's view is that the Commission's resources should be focussed on targeting serious or deliberate breaches of price-quality paths, rather than minor or inadvertent infringements.

PART 6: COST OF CAPITAL

- 6.1 Orion has had the opportunity to review the submission on cost of capital prepared by the ENA, along with the accompanying reports by PricewaterhouseCoopers and LECG. Orion supports that submission in its entirety and adopts its conclusions as its own.
- 6.2 In particular, Orion supports the view expressed in the ENA submission that the Commission is legally required, because of the primary importance of the objective in s 52A(1)(a), to ensure that the cost of capital IM that it determines is set at or above the true value of the cost of capital. The Commission's present proposal fails to do so, because the Commission has taken no or insufficient account of the need to correct for model choice error and parameter estimation error.
- 6.3 In correcting for error, the Commission must err on the side of overestimating rather than underestimating the cost of capital. That is because any underestimate of the true value of the cost of capital is impermissible under s 52A(1)(a).
- 6.4 Orion also draws the Commission's attention to its obligation under s 26 to have regard to the 2006 Government Policy Statement on "Incentives of Regulated Business to Invest in Infrastructure" and, particularly, the statement that the Government considers its objectives will be achieved by "regulated rates of return being commercially realistic and taking full account of the long-term risks to consumers of underinvestment". That statement reinforces the proposition that the cost of capital adopted must be commercially realistic before it can ensure adequate investment, as required by s 52A(1)(a).
- 6.5 Orion notes that the Commission's decision to rely exclusively on the Brennan-Lally form of the CAPM model to estimate the cost of equity is out of line with the recommendations of the two international finance experts – Professor Stewart Myers and Professor Julian Franks - engaged by the Commission in 2008 to advise it on the appropriate methodology for estimating the cost of capital. Professors Myers and Franks, whom are among the most respected finance academics in the world, expressed strong reservations about the simplifying assumptions in the Brennan-Lally

form of the CAPM¹, as well as the exclusive reliance on the CAPM model in general.

- 6.6 Professor Myers stated that the dividend imputation assumptions underlying the Brennan Lally CAPM would lead to *underestimates* of the cost of equity, particularly for low beta and/or low risk firms, and recommended that a classical CAPM model be adopted instead.² Professor Franks also recommended that separate estimates should be made using the classical form of CAPM. Both these findings are consistent with Orion's submission to the Commission³ at the outset of the process for developing its cost of capital guidelines.
- 6.7 Professors Myers and Franks also recommended that the Commission employ discounted cash flow (DCF) and Fama-French three-factor model estimates of the cost of equity as cross checks on CAPM estimates. They noted that *all of these models are imperfect tools*, that judgement was unavoidable in their application, and that the Commission should *review the evidence available from all of these models and exercise its judgement*.
- 6.8 Orion recommends that the Commission develop cost of capital input methodologies that reflect the advice of these highly respected experts. To do so would be consistent with and could be expected to reinforce the ENA's recommendation that the Commission apply a margin of 1 per cent in its estimation of the cost of capital to take account of model error.

¹ Julian Franks, Martin Lally, Stewart Myers, *Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology*, 18 December 2008, p 11.

² *Ibid*, p 9, 11

³ See: NERA, *Commerce Commission Cost of Capital Guidelines*, December 2005

PART 7: ASSET VALUATION

Summary

- 7.1 Orion's submission on the approach taken by the Commission to asset valuation in its draft reasons paper is as follows:
- 7.1.1 The Commission's task is to determine an asset valuation IM that best meets the purpose statements in section 52A (for Part 4, generally) and section 52R (for IMs, specifically).
 - 7.1.2 To meet the purpose statements, the IM must promote outcomes consistent with those produced in workably competitive markets, as prescribed in section 52A.
 - 7.1.3 The Commission's approach is unlikely to achieve this purpose, because it cannot produce initial asset values that would be observed in a workably competitive market.
 - 7.1.4 A materially better approach based on orthodox economic principles would be to establish initial asset values by estimating a fresh ODV of EDBs' system fixed assets as at 2010 using an up-to-date handbook.
 - 7.1.5 The Commission could update this initial 2010 valuation in a number of ways, with Orion's preference being the use of periodic ODV resets.
 - 7.1.6 If there are any concerns about the prospect of "windfall gains" (eg, if 2010 replacement costs are believed not to reflect long-run equilibrium), then this can be addressed by committing to repeat ODVs.
- 7.2 We have had the opportunity to review the draft submission on asset valuation prepared by the ENA. We endorse the ENA's views relating to the development of the initial regulatory asset base (RAB) and adopt its conclusions as our own. We also concur with the ENA's view that there are a number of ways in which to update the initial RAB that are potentially

consistent with the purpose statement, including approaches that involve periodic ODV resets and approaches that 'lock-in' initial asset values.¹

7.3 Below we elaborate on some matters of particular concern to Orion.

Potential Initial Asset Valuations

7.4 There are two principal valuation approaches that the Commission considers in its Draft Reasons Paper. These are:

7.4.1 to set an opening value based on the 2009 information disclosure accounts for each business, *ie*, the 2004 ODV adjusted for new assets valued at indexed historical (or 'actual' costs²) disposals and depreciation, with various other 'corrections' (discussed below) (a '**partially corrected 2004 ODV**' – the Commission's preferred approach³); and

7.4.2 to estimate a new ODV as at 2010 using an improved methodology and up-to-date information on unit replacement costs (a '**fresh 2010 ODV**' – Orion's preferred approach).

7.5 Both are *replacement cost* methodologies. The principal difference is that Orion's preferred option involves estimating a 'fresh' ODV as at 2010, whereas the Commission's preferred option involves making modest changes to a *six year old* replacement cost valuation. Although the Commission seeks to characterise its 'partially corrected' 2004 ODV as a 'deemed' historical cost value,⁴ this is demonstrably not the case – it is an (out-of-date) ODV estimate.

7.6 In the remainder of this submission we explain why it would be materially better for the Commission to set the initial RAB values for EDBs based on a fresh 2010 ODV.

¹ A point of difference between Orion and the majority of ENA members (which the Commission highlights in its Draft Reasons Paper) is that we have consistently supported periodic ODV resets, and continue to prefer such an approach over the Commission's proposed IHC roll-forward methodology. However, we acknowledge that myriad approaches are potentially capable of promoting a workably competitive market outcome.

² The exception being vested assets (*ie*, assets for which EDBs do not incur actual construction costs), which are included at the applicable unit costs as per the 2004 Handbook.

³ Draft Reasons Paper, p 98

⁴ Draft Reasons Paper, para 4.3.1

The Purpose Statement

7.7 The starting point for the Commission must be to determine an IM that meets the purpose statement in section 52A. Orion has already briefly addressed questions of legal analysis in Part 1 of this submission, but it is convenient to reproduce section 52A at this point:

- (1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
 - (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
 - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
 - (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
 - (d) are limited in their ability to extract excessive profits.

7.8 A central feature of the purpose statement is the obligation upon the Commission to promote outcomes consistent with those seen in workably competitive markets.⁵ Orion considers that the orthodox application of this principle provides clear guidance for the initial valuation of the fixed assets and for the way in which those asset values may be updated over time, as we describe below.

*ODV is Preferred for Setting Initial Asset Values*⁶

7.9 At any point in time and in the absence of any other contextual information, the *best approximation* of an asset's value in a workably competitive market is its optimised deprival value (ODV).⁷ We acknowledge that

⁵ As Professor Alfred Kahn explains, 'the single most widely accepted rule for the governance of the regulated industries is to regulate them in such a way as to produce the same results as would be produced by effective competition, if that were feasible. Microeconomic theory provides regulators with a set of principles that, if followed, will produce optimum results, by widely accepted criteria of optimality.' See: Kahn, A., 1988, *The Economics of Regulation, Principles and Institutions, Volume 1 – Economic Principles*, Massachusetts Institute of Technology, p 17.

⁶ This section draws extensively upon the report by our economic advisors, NERA, entitled: *Asset Valuation*, 19 August 2010.

⁷ The applicable ODV of an asset is either its optimised depreciated replacement cost (ODRC) or, if the service could realistically be provided at a reduced cost to users by some other means, its economic value. See: Commerce Commission, *Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses*, 30 August 2004.

because entry and exit are not costless in such markets it is possible for periods of 'disequilibrium' to occur during which asset values may depart from replacement costs, *ie*:⁸

7.9.1 if market demand increases (*eg*, due to shift in demand in a downstream market), then excess demand may give rise to prices in excess of the underlying costs of supply; and

7.9.2 if market demand decreases (*eg*, due to fall in demand in a downstream market), then excess supply may produce prices below the underlying costs of supply.

7.10 However, this does not detract from the general principle because such periods are only temporary. The very fact that such markets are workably competitive implies that disequilibrium cannot be permanent, and that a re-alignment process will be under way.⁹ If businesses cannot make normal economic returns that meet the replacement costs of the relevant assets, then market entry will be delayed and/or exit hastened. Conversely, if businesses are seen to be making greater than normal economic returns, entry will occur to erode those margins.

7.11 In the long run, once new entry or exit has occurred and the incentives for further entry or exit have ceased, it must be the case that any supplier in that market just makes normal returns.¹⁰ The long-run equilibrium outcome is one that is characterised by asset values that reflect the applicable ODV.¹¹ Furthermore, there is no reason to think that short-term fluctuations above or below ODV that occur during periods of disequilibrium will be biased in either direction. Periods of excess supply and excess demand are equally likely.¹² This conclusion is also consistent with the available empirical estimates of Tobin's Q.¹³

7.12 We recognise that asset values may also depart from ODV in workably competitive markets where the terms of a long-term supply agreement involve an arrangement or understanding that prices will be determined by

⁸ NERA, *Asset Valuation*, 19 August 2010, p 7

⁹ NERA, *Asset Valuation*, 19 August 2010, p 7

¹⁰ *Ibid*, p 8

¹¹ *Ibid*

¹² *Ibid*, p 9

¹³ *Ibid*

some means or other that may not be consistent with regularly updated replacement costs. However, the nature and extent of commitments arising under any long-term contract, and its implications for the relationship between prices, the cost of supply and so the value of any assets necessary for the provision of the services specified by that contract, are ultimately *questions of fact, ie*:¹⁴

7.12.1 if there is a clear prior understanding that asset values (whether expressly or implied) will be based on an arrangement or understanding memorialised in a long-term, fixed-price contract, then such values can reasonably be said to form the basis of prices struck in a workably competitive market; and

7.12.2 if no such understanding exists, then the best approximation of the initial valuation of the fixed assets of a firm in a workably competitive market is the ODV of those assets at that point in time.

7.13 Importantly, the *mere potential* for such prior arrangements does not diminish the relevance of the ODV principle.¹⁵ No firm can be expected to enter into a long-term contract unless it has a reasonable expectation that the cost of the assets that need to be used or put in place can be recovered, including a normal return on capital.¹⁶

7.14 Moreover, it is commonplace for long-term contracts to contain reset/renegotiation clauses that, when exercised, will also serve to correct any divergence between contract prices and costs.¹⁷ No doubt, on occasion, as market conditions change periods of higher or lower than normal returns will occur. However, even if there is no reset/renegotiation clause there is no reason to expect that the replacement cost of any relevant assets will be systematically higher or lower than the market value one would expect to observe in a workably competitive market. Any suggestion to the contrary contemplates irrational conduct on the part of the contracting parties, because either:¹⁸

¹⁴ *Ibid*, p 15

¹⁵ NERA, *Asset Valuation*, 19 August 2010, p 15

¹⁶ Similarly, no customer will agree to pay a contract price that it expects will over-represent the market price. See NERA, *Asset Valuation*, 19 August 2010, p 15.

¹⁷ NERA, *Asset Valuation*, 19 August 2010, p 15

¹⁸ *Ibid*, p 16

- 7.14.1 the seller would voluntarily be committing to receiving a contract price that it expects will under-represent the forward-looking market value, eg, if the ODV of the assets was anticipated to be systematically above their implied contractual value; or
- 7.14.2 the buyer would voluntarily be committing to paying a contract price that it expects will exceed the forward-looking market price, eg, if the ODV of the assets required to supply the good or service was expected to be systematically below their implied contractual value.
- 7.15 It follows that a strong relationship remains between the asset values derived on the basis of ODV principles, and the values that are expressed or implied by the terms of a long-term contract. Specifically, in a regulatory context, returns based on ODV provide the best estimate of outcomes produced in workably competitive markets.
- 7.16 *Clear guidance* is therefore offered by the economic concept of ‘workable competition’ for the valuation of the fixed assets of a firm supplying goods or services in a workably competitive market. Unless there is *empirical evidence to suggest otherwise* (eg, asset valuations expressed or implied by the terms of a long-term, fixed-price contract), the best approximation of an asset’s value at any point in time in a workably competitive market is *its ODV*. It follows that unless the Commission can point to a prior understanding that *something other* than a measure of current replacement costs will be used to set the initial RAB for EDBs upon the inception of control, in order to promote an outcome consistent with a workably competitive market outcome, it must determine an accurate estimate of replacement costs.
- 7.17 In this respect, it cannot reasonably be suggested that there was a prior arrangement or understanding that something other than an estimate of current replacement costs would be used to set prices upon the inception of control. No historical cost estimates are available and recent capital markets transactions sales prices for network businesses are not systematically available as a starting point. In addition to the obvious absence of alternatives, there is also the fact that the Commission has routinely employed the ODV methodology in the past – as have regulators in Australia when faced with the equivalent task.¹⁹

¹⁹ See NERA, *Asset Valuation*, 19 August 2010, pp 12-14.

7.18 In short, in order to produce an initial asset valuation that promotes an outcome consistent with those observed in workably competitive markets as required by the legislative purpose statement, the Commission should determine an estimate of the ODV of EDBs' system fixed assets. But at *what date* must that estimate of the ODV be determined? In Orion's view, the materially better approach is to determine a fresh ODV *as at 2010*.

A 2004 ODV or a 2010 ODV?

7.19 The task for the Commission is to choose an approach that, in its judgement,²⁰ does not have a *materially better alternative*. This means that the Commission needs to adopt an approach that *best* delivers against the workable competition standard. The Commission has expressed a preference for using, in effect, a partially corrected 2004 ODV (which it mischaracterises as a 'deemed' historical cost²¹). Its primary reasons for this preference stem from:

7.19.1 its analysis of long-term contracting which, in reality, is an unhelpful distraction that provides no justification for favouring a partially corrected 2004 ODV over a fresh 2010 ODV; and

7.19.2 its flawed analysis of the criteria contained in sections 52A(1)(a) and 52A(1)(d) that leads it to conclude that a fresh 2010 ODV would not be as effective at meeting these requirements; and

7.19.3 its misguided assertion that 'accuracy' is not a relevant consideration when implementing an ODV methodology.

7.20 None of these reasons are persuasive for the reasons set out in detail in paragraphs 7.42 – 7.69 below. They reflect significant errors in the Commission's reasoning. The Commission's *principal* concern with adopting a fresh 2010 ODV, rather than the partially corrected 2004 ODV, seems to be that the higher standard unit replacement costs in 2010 will lead to a higher initial RAB. In other words, its preference for a partially corrected 2004 ODV is motivated primarily by its aspiration for a lower opening asset value and lower prices.

²⁰ The existence of appeal rights recognises the fact that the Commission may, from time to time, get things wrong.

²¹ Draft Reasons Paper, para 4.3.1

- 7.21 This stems from the misguided notion that a lower initial RAB is superior to a higher initial RAB. That is not so. The mere fact that a partially corrected 2004 ODV is likely to be lower than a fresh 2010 ODV does not mean that it is *materially better*. In Orion's view, in order for a partially corrected 2004 ODV to better meet the requirements of the purpose statement, the Commission would need to be satisfied that the replacement costs that it estimates were a closer reflection of a long-run equilibrium in a workably competitive market than the replacement cost estimates generated by a fresh 2010 ODV.
- 7.22 However, that approach leads, at a superficial level, to something of a stalemate, because there is nothing to say that either number is intrinsically superior or more accurate in terms of yielding a value that better fits the long-run equilibrium. In a sense, both are snap-shots of a moment in time and, for that reason, somewhat arbitrary. But two factors break that stalemate and point decisively towards adopting the fresh 2010 ODV value:
- 7.22.1 the enactment of a new regulatory regime, which requires the Commission to determine IMs by a particular date (30 June 2010, now extended to 31 December 2010), indicates that what is required is a fresh valuation as at 2010; and
- 7.22.2 the more up-to-date ODV is more likely to be a more accurate estimate of *today's replacement costs*, given the absence of any information to suggest that the current replacement unit cost position is aberrational.
- 7.23 The absence of any information suggesting that the 2010 ODV value is aberrational should assuage the Commission's apparent concern that adopting a fresh 2010 ODV as the initial RAB might somehow lead to a "windfall gain". If the fresh 2010 ODV value is not based on an aberration, there is, by definition, no windfall gain; the value yielded simply reflects that which would be expected to obtain in a workably competitive market. It is no more likely that the fresh 2010 ODV is a "windfall gain" than that the partially corrected 2004 ODV represents a "windfall loss".

Movements in Asset Values

- 7.24 Once it has established the initial RAB, the Commission's task is to specify the way in which that value will be updated over time. Orion considers that there are many different ways that the Commission might update initial RAB values that are potentially consistent with workably competitive

market outcomes. The final IM must ultimately be the sum of many decisions on many matters, including:²²

7.24.1 whether *to periodically update* the RAB to reflect 'current' optimised deprival values and, if so:

- (a) *how frequently to undertake such revaluations, eg, whether to revalue the RAB annually, every five years, and so on;*
- (b) *whether to include an allowance in regulatory prices for forecast revaluation gains and, if such allowance is made, how any outturn differences from those forecasts will be dealt with at the time of a revaluation, ie:*
 - (i) *whether outturn revaluation gains (losses) will be included as income (expenses) when determining the forward-looking revenue requirement; or*
 - (ii) *whether outturn revaluation gains (losses) will be retained by EDBs, in the expectation that such gains (losses) will be offset by future losses (gains) over the longer-term;*

7.24.2 whether to *'lock in' the initial RAB* and restrict subsequent movements to additions, disposals, depreciation and, say, annual revaluations by reference to an index, *eg, the consumer price index, the producer price index or some other alternative;*²³

7.24.3 the *depreciation profile* to employ, *eg, whether 'straight-line' depreciation is used, or whether the allowance shall be based on forecast measures of replacement costs (if periodic ODV resets are undertaken); and*

7.24.4 the treatment of *additions and disposals*, including the application of *ex-ante and/or ex-post* prudence tests for new capital expenditure (if a 'lock-in' approach is adopted).

7.25 Regardless of how the Commission chooses to utilise these various tools that it has at its disposal for updating asset values over time, it will not be

²² NERA, *Asset Valuation*, 19 August 2010, pp 22-24

²³ For example, it may be the case that the *producer* price index is a superior predictor of movements in replacement costs for EDBs than the consumer price index.

able to replicate perfectly the way in which assets are valued in markets in which the cost and demand structures are conducive to workable competition. Its challenge is to promote such outcomes (as identified in paragraphs (a) to (d) of the s 52A purpose statement) as best it can. There are many ways that it might set about this task.

7.26 For example, Orion has consistently supported approaches that involve periodic ODV resets. We remain of the view that such an approach would promote workably competitive market outcomes. However, we acknowledge that such an approach is not the *only way* that the Commission might achieve this objective. There are myriad other variants of a 'periodic ODV revaluations' approach and a 'roll-forward' approach that also have the potential to promote workably competitive market outcomes.²⁴

7.27 Further, the various tools available to the Commission in updating the ODV over time provide the Commission with ways of addressing any concerns the Commission has with adopting as an initial RAB a fresh 2010 ODV.

7.28 If (which is not accepted) the Commission takes the view that there is some basis on which to suppose that a fresh 2010 ODV is somehow reflective of aberrational replacement unit costs and does not reflect long-run equilibrium, the way to approach the issue is *not* to set an initial ODV based on outdated values that are equally unlikely to reflect long-run equilibrium. Rather, any concerns that a 2010 ODV may not accurately reflect long-run replacement costs can be addressed by committing to repeat ODVs (Orion's preferred approach) or, if an IHC approach is employed, through the Commission's choice of index.

Fulfilment of Criteria (a) – (d)

7.29 If the Commission establishes an asset valuation IM that promotes the outcomes that are produced in workably competitive markets, it follows that the criteria set out in section 52A(1)(a)-(d) will be met. In particular, if the Commission establishes the initial asset values based on an estimate of the ODV of EDBs' system fixed assets *as at 2010* and introduces a compliant roll-forward methodology, EDBs will:

7.29.1 have incentives to innovate and to invest, including in replacement, upgraded, and new assets (criterion (a)); and

²⁴ See NERA, *Asset Valuation*, 19 August 2010, pp 23-24.

7.29.2be limited in their ability to extract excessive profits (criterion (d)).

7.30 One of the principal purposes of criterion (a) is to ensure that the Commission does not engage in short-sighted *regulatory opportunism* by valuing sunk assets *inappropriately low* so as to deliver reduced prices to consumers in the short term. Such conduct would harm businesses' future incentives to invest and innovate since they would not be confident of securing a reasonable return on such outlays. In contrast, establishing initial asset values based on an estimate of current replacement costs avoids this problem and will deliver appropriate incentives.

7.31 In the context of criterion (d), 'excessive profits' are those systematically in excess of those a business would be expected to earn in a workably competitive market. It follows that replicating a workably competitive market outcome by establishing initial asset values based on current replacement costs cannot deliver excessive prices or profits. This is tautological. We also do not consider that the Commission's concerns surrounding the potential for such an approach to deliver so-called 'windfall gains' are valid for the reasons we set out in paragraphs 7.59, below, and following.

Summary

7.32 In order to produce an initial asset valuation that best achieves the requirements of the section 52A purpose statement, the Commission should determine an estimate of replacement costs *as at 2010*. However, there are myriad potential ways that the Commission might update that initial RAB over time that are potentially consistent with the workably competitive market benchmark. Orion has consistently supported approaches that involve periodic ODV resets, although we recognise that this is not the only approach available to the Commission.

7.33 In contrast, it is unclear whether the approach espoused by the Commission in its Draft Reasons paper will result in initial asset valuations that are consistent with the outcomes of workable competition. It may not, in which case it will not have complied with the requirements of the purpose statement. At the very least, there is a materially better alternative available to it that we describe in paragraphs 7.70 – 7.73, below.

The Commission's Draft Decision

7.34 The Commission has repeatedly (and in Orion's view incorrectly) suggested that the section 52A workable competition standard offers little

or no guidance for the selection of an appropriate initial asset valuation or for the way in which asset values should be updated over time. Rather unhelpfully, the Commission has repeatedly repositioned the requirements of the workable competition standard throughout the consultation process, *ie*:

7.34.1 In the IM discussion paper (June 2009), it asserted that “dynamic efficiency considerations are of primary importance in establishing the initial value of the RAB in a way that is consistent with s 52A(1)(a) and (d)”.²⁵ The Commission also suggested that “...the purpose of Part 4 would be promoted effectively if earlier valuations are used (where feasible)”.²⁶

7.34.2 In its IM emerging views paper (December 2009), it averred that “a number of possible RAB approaches are consistent with promoting outcomes consistent with outcomes produced in workably competitive markets”,²⁷ and “all other things being equal, setting an initial RAB value that is consistent with the long-term benefit of consumers suggests setting a lower rather than a higher value”.²⁸

7.34.3 In its Draft Reasons Paper, it refers to the lack of a “best practice” approach and the “absence of clear statutory guidance” as demanding the exercise of regulatory judgment in setting the asset valuation methodology.²⁹

7.35 In its Draft Reasons Paper, the Commission approaches the workably competitive market benchmark by hypothesising as to the kind of competition that *would be most likely to occur* if competition in the market for electricity lines services was indeed workable.³⁰ It contends that workable competition in markets with characteristics similar to electricity lines services would involve a scenario in which long-term contracts are the major form of supply relationship.³¹

²⁵ Commerce Commission, *Input Methodologies Discussion Paper*, June 2009, para 6.71

²⁶ *Ibid*, para 6.107

²⁷ Commerce Commission, *Input Methodologies (Emerging Views) Paper*, December 2009, para C28

²⁸ *Ibid*, para C29

²⁹ Draft Reasons Paper, para 4.2.8

³⁰ Draft Reasons Paper, paras 4.2.25-4.2.32. See also: Yarrow *et al*, p 27.

³¹ Draft Reasons Paper, paras 2.7.23, 4.2.25-4.2.32. See also: Yarrow *et al*, p 29.

7.36 The Commission concludes that the consequence of such an interpretation is that asset values in such markets will be heavily influenced by ‘historical events’. This is because, were the market for electricity lines services to be workably competitive in the way it suggests, the contract terms would reflect the economic conditions and expectations *at the time the contract was struck*. The Commission further contends that such historical events may be significantly different from present conditions.³² Specifically, it contends that:³³

7.36.1 it is common for asset values to diverge from replacement costs (and historic costs) in workably competitive markets, particularly those with similar economic characteristics to the market for electricity lines services; and

7.36.2 continuity in regulatory asset values would be consistent with outcomes produced in workably competitive markets, particularly those with similar economic characteristics to the market for electricity lines services.

7.37 The Commission also observes that there is a ‘good prospect’ that the valuations resulting from new replacement cost valuations will differ from existing regulatory values.³⁴ It concludes that ‘this is not required’ by the reference to workably competitive markets and would not promote the long-term benefit of consumers or limit EDBs’ ability to extract excessive profits in the future.³⁵

7.38 For these reasons, the Commission concludes that the initial RAB value for each EDB should be the value of assets provided in their 2009 disclosure accounts prepared pursuant to the Electricity Information Disclosure Requirements 2004, with a number of adjustments, including (amongst other things):³⁶

7.38.1 corrections for errors found during audits;

7.38.2 the application of more appropriate multipliers; and

³² Draft Reasons Paper, para 2.7.9; and Yarrow *et al*, p 36.

³³ Draft Reasons Paper, para 4.2.38

³⁴ Draft Reasons Paper, para 4.3.16

³⁵ Draft Reasons Paper, para 4.3.45

³⁶ Draft Reasons Paper, p 98

7.38.3 the inclusion of assets previously optimised out of the 2004 ODVs, or written down under an economic value test, but that are now used in the supply of electricity lines services.

- 7.39 The Commission proposes to update the initial RAB by 'locking in' the partially corrected 2004 ODVs, and restricting subsequent movements to additions (at cost), disposals, depreciation and annual revaluations at the rate of consumer price inflation. Very little is said about the application of prudence tests to new capital expenditure, which is a noticeable omission that we elaborate upon below. In reaching its draft decision, the Commission also contends that it would be 'fundamentally inconsistent' to undertake a 'new ODV' to establish initial asset values, but then to roll the RAB value forward 'without future ODVs'.³⁷
- 7.40 The Commission seeks to characterise its proposed approach as an *indexed historical cost* (IHC) methodology by suggesting that the 2004 ODV is a 'deemed' historical cost value.³⁸ However, this is demonstrably not the case. In fact, the Commission's approach involves updating an *earlier ODV valuation* by rolling that value forward without periodic ODV revaluations. In other words, the Commission's proposed approach is a *replacement cost methodology*.
- 7.41 To summarise, the Commission's draft decision is to 'lock in' the 2009 disclosure values with some modest corrections and to 'roll forward' those values without subsequently revisiting them. This approach is in stark contrast to the approach suggested by the economic and legal principles that we traversed in the previous section. There are serious problems with the Commission's approach which is not well reasoned and, as it stands, may not meet the requirements of the purpose statement or, at the very least, ignores the materially better alternative of a fresh 2010 ODV. We explain why below.

Problems with the Commission's Approach

- 7.42 The Commission makes a number of errors in its Draft Reasons Paper that result in an asset valuation IM that may not meet the requirements of the purpose statement and, at the very least, ignores the materially better alternative of a fresh 2010 ODV. The most fundamental problem with the Commission's approach is that it relies on an incorrect interpretation of the

³⁷ Draft Reasons Paper, para 4.3.94

³⁸ Draft Reasons Paper, para 4.3.1

workably competitive market benchmark. In particular, its reliance on the paradigm of long-term contracting is an unhelpful distraction that, in reality, provides no support for its draft decision.

- 7.43 The Commission's dismissal of a 'new replacement cost valuation' on the grounds that it may result in price increases is similarly misplaced, and its proposition that accuracy is an irrelevant consideration when employing an ODV methodology is untenable. Finally, its contention that it would be 'fundamentally inconsistent' to undertake a 'new ODV' to establish initial asset values, but then to roll the RAB value forward 'without future ODVs' is wrong as a matter of economics. We describe these errors in the Commission's analysis below.

(a) *Irrelevance of Long-term Contracts*

- 7.44 It is neither useful nor appropriate for the Commission to hypothesise what kind of competition would be most likely to occur if competition in the market for electricity lines services was indeed workable. The problem with such an approach is that competition in infrastructure markets *is not workable*. Speculating as to what kind of competition might be workable serves only to unduly restrict its focus to a hypothetical market with idiosyncratic characteristics for which the workability of competition is, at best, doubtful. Such contrivances therefore risk overlooking the potential lessons from markets in which there *actually is* workable competition.
- 7.45 The Commission also appears to have a very narrow conception of what a 'hypothetical long-term contract' for the supply of electricity distribution services would look like. In particular, the Commission appears to hypothesise that, once contract prices had been set, these would quickly depart from replacement costs, thereby reducing the relevance of the ODV valuation principle. The Commission also appears to hypothesise that the agreed contract price would apply (perhaps with indexation) in perpetuity, without ever needing to be revisited.
- 7.46 Quite apart from the highly contrived nature of such an arrangement, there is the more fundamental problem that a contract for the delivery of electricity distribution services with such characteristics is simply inconceivable. NERA highlights that the literature on franchise bidding for utility services is replete with cautions about the impracticability of long-

term contracts in such circumstances.³⁹ Indeed, Professor Yarrow (a co-author of the Expert Report) acknowledged in an earlier publication that:⁴⁰

[T]here are many industries where franchising cannot work, at any rate in this simple form, and the industries described later in this book (**energy**, telecommunications, water, etc.) provide leading examples. We shall focus on three sources of difficulty – the danger that bidding for the franchise will be uncompetitive, problems of asset handover, and most important, the difficulties of contract specification and monitoring' (emphasis added)

- 7.47 In other words, one *cannot* reasonably contrive a hypothetical long-term contract of the kind postulated by the Commission and Yarrow *et al* (nor, it would seem, could Professor Yarrow himself when penning his book with John Vickers). There is also an obvious tension between the Commission's willingness to postulate an implausible hypothetical long-term contract, but its reluctance to embrace the hypothetical new entrant (HNE) test⁴¹ that underpins the ODV methodology. The long-term contract paradigm that the Commission espouses is no less hypothetical than the HNE test but is without precedent in any regulatory proceeding of which we are aware.
- 7.48 Even if one could conceive of such a contract, there is no reason to think that there would be any systematic inconsistency between the asset values that would underpin such a contract and those valued in current cost terms. We explained above that no firm can be expected to enter into a long-term contract for supply of goods or services unless it has a reasonable expectation that the cost of the assets it needs to put in place (for which it will incur costs equal to their ODV) can be recovered, including a normal return on capital. Of course, once that contract has been running for a while the value of the assets used to supply the services specified in

³⁹ In his seminal work on the scope for franchise bidding to substitute for the regulation, Professor Williamson highlights its unsuitability for this purpose in many circumstances. In particular, he observes that franchise bidding for public utility services under conditions of uncertainty 'encounters many of the same problems that the critics of regulation associate with regulation' and is a 'much more dubious undertaking' than the literature prior to that point had acknowledged. See Williamson, Oliver E, 'Franchise bidding for natural monopolies – in general and with respect to CATV', *Bell Journal of Economics*, 1976, p 78.

⁴⁰ John Vickers and George Yarrow (1989), *Privatization: An Economic Analysis*, Cambridge, Mass: MIT Press, p 111.

⁴¹ The HNE test seeks to derive the price that an HNE would be prepared to pay to buy an incumbent's assets as compared with the alternative of building a new network – recognising that by purchasing second-hand assets it will face the prospect of higher maintenance costs and earlier replacement. In other words, the fundamental purpose of the HNE test is to establish regulatory asset values and prices that will place the HNE on an equal footing with the incumbent on a forward-looking basis, however unlikely the prospect of *actual* entry may be. The price that an HNE would be prepared to pay to enter the market under these circumstances corresponds to the ODV of the incumbent's assets. See: NERA, *Asset Valuation in Workably Competitive Markets*, 15 October 2009, pp 10-11.

the contract may well have departed from the replacement cost standard.
However:

7.48.1 there is no reason to expect that, *ex ante*, replacement costs will systematically be higher or lower than contract prices, *ie*, replacement costs may either increase or decrease in real terms, but there is no 'in principle' way of knowing beforehand; and

7.48.2 it is commonplace for long-term contracts to contain reset/renegotiation clauses that allow the agreed price to be updated so as to reflect current market conditions, and so current replacement costs.

7.49 In other words, a more fulsome examination of the principles underpinning the role of long-term contracts in markets for which these are the prevalent basis for price formation would have revealed that there is *no inconsistency* between assets valued in current cost terms, the values that one would expect to underpin a long-term contract and, ultimately, the asset values that one would expect to observe in a workably competitive market. Such an examination would also have revealed the sheer implausibility of the Commission's postulated model of workable competition (which is distinctly *unworkable*) and highlighted the obvious inconsistency with its reticence to embrace the HNE test that underpins the ODV methodology.

7.50 Ultimately, the Commission's approach involves it defining the workably competitive market standard as widely as possible, and then narrowing in on a highly stylised hypothetical paradigm of long-term contracting that is, at best, barely workable and, at worse, inconceivable. The workably competitive market standard is far more exacting than the Commission professes, and does not allow it to 'cherry pick' in this fashion. In our view, the Commission's proposed approach ignores orthodox economic principles – which point to a fresh 2010 ODV – and risks subverting the purpose of the legislation, which was intended to engender certainty and foster efficient investment.

7.51 For these reasons, the Commission's analysis of long-term contracts does not detract from the conclusion that to meet the requirements of the purpose statement, it must determine an estimate of replacement costs as *at 2010*. Moreover, the other reasons that the Commission relies on to eschew estimating current replacement costs are similarly unconvincing.

(b) Dismissal of New Replacement Cost Valuation

7.52 The Commission sets out several other reasons (in addition to its misplaced analysis of long-term contracts) for not establishing initial asset values on the basis of current replacement costs. These can be summarised as follows:

7.52.1 that there is a 'good prospect' that new replacement cost valuations will differ from the existing disclosure values, and:

- (a) the potential for 'downward revaluations' is undesirable if it makes suppliers worry that future investments may also be written down (*ie*, s 52A(1)(a)); and
- (b) the potential for 'upward revaluations' that are not justified on the basis of efficiency gains would be less effective at limiting suppliers in their ability to extract excessive profits (*ie*, s 52A(1)(d)); and

7.52.2 that 'accuracy' is not a meaningful objective when estimating an ODV because of the degree of subjectivity involved.

7.53 As a general observation, the mere fact that new valuations may differ from existing valuations is, of itself, a weak justification for using a partially corrected 2004 ODV. The purpose of the new legislation was to usher in change. Indeed, it is hard to imagine that Parliament's purpose was to preserve the status quo to the greatest extent possible. In any event, linking prices to *any* asset valuation – including the partially corrected 2004 ODVs will involve price changes, since those values were not used to establish current prices. The Commission and EDBs must therefore be prepared to accept price increases or decreases, regardless of how the initial RAB is set. Indeed, the Commission's recently released Discussion Paper on its proposed approach for undertaking starting price adjustments recognises as much.⁴²

7.54 The Commission's more specific reservations about the prospect for future downward revaluations and the potential effects on EDBs' incentives to invest are similarly unpersuasive. From Orion's perspective, we accept that periodic ODV resets give rise to the possibility that the value of our

⁴² See Commerce Commission, *Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*, 5 August 2010.

investments may be written down in the future. We are happy to face the prospect of such downward adjustments provided that we are also able to benefit from *upward adjustments*. These risks are no different to those faced by most firms operating in workably competitive markets.

- 7.55 At present, we are more concerned with the potential for downward adjustments to result from the application of *ex-ante and/or ex-post prudence tests*. There is a conspicuous absence of discussion in the Draft Reasons Paper of the circumstances in which new capital expenditure will be incorporated into the RAB under the Commission's proposal approach. This represents a significant shortcoming in the paper. Until EDBs are cognisant of the criteria that will be employed to assess the prudence of investments, it is impossible to know whether there is a greater risk of downward adjustments arising from a 'periodic ODV reset' approach or from the Commission's proposed IHC approach. The Commission infers that such risks are confined to approaches that involve periodically revisiting the RAB, but that is not the case.⁴³
- 7.56 To that end, if the Commission is genuinely concerned about the prospect of sharp downward reductions in asset values from future ODV resets then this can be addressed by 'locking in' the initial RAB in the manner described above and clearly articulating appropriately defined prudence tests for new capital investments. The Commission has *proposed already* to do the former (albeit from an inappropriate starting point), but it is yet to do the latter. (This represents a significant, but readily addressable deficiency in its Draft Reasons Paper.)
- 7.57 The Commission's observation that 'accuracy' is not meaningful with respect to ODV estimates is also incorrect, and cannot be relied upon to obviate the need to produce an estimate of replacement costs as at 2010. We readily accept that there will be a degree of subjectivity involved in producing up-to-date valuations. However, that does not mean that the Commission should not try to get the best estimate possible, and it does not excuse it averting its eyes to material deficiencies in the 2009 disclosure values. If the Commission is seriously suggesting otherwise, we find that untenable.

⁴³ Similarly, although Orion accepts that there are likely to be significant periodic administrative costs associated with ODV revaluations, there may be similar (and perhaps even greater) costs involved with pervasive prudence tests.

- 7.58 Indeed, the fact that it has been prepared to contemplate certain corrections to the 2004 ODVs (as represented by the 2009 disclosure values) is a tacit acknowledgement that accuracy *is* important. Unfortunately, those corrections do not go far enough and fall short of producing an accurate estimate of current replacement costs. In our view, it is incumbent on the Commission to make a significant number of additional changes to the 2004 ODV Handbook (by which the 2009 disclosure values have been derived) in order to arrive at an accurate estimate of replacement costs as at 2010. We describe the changes that must be made in paragraph 7.60, below.
- 7.59 The Commission's final concern is perhaps its most significant. Put simply, it appears to be concerned that establishing initial asset values on the basis of current replacement costs would result in material price increases. Orion has had the opportunity to review the 2010 ODV Handbook that has been prepared by PwC. It is clear from that document that setting the initial asset values based on a 'fresh' 2010 ODV would indeed result in a significant uplift as compared with partially corrected 2004 ODVs (the Commission's preferred approach).
- 7.60 In our view, the majority of the proposed changes set out in the 2010 Handbook should be readily accepted since, for the most part, they involve *correcting the methodology* that was used to estimate the 2004 ODVs and, by extension, the 2009 disclosure values in light of superior information that has been obtained in the interim. These changes would include (amongst other things) the proposed revisions to the replacement cost multipliers, changes to the total asset life assumptions, updated provisions for depreciation, an allowance for working capital and the incorporation of easements at current replacement cost. A more comprehensive description of the required changes is provided in the following section.
- 7.61 The fact that these changes are likely to result in an increase in EDBs system fixed asset values is irrelevant, since they are *required to correct the 2004 values*. In other words, the changes apply *equally to the Commission's preferred approach*, since they are needed to *properly* (rather than 'partially') correct the 2004 ODVs. Simply rolling forward the 2004 ODVs cannot provide a reasonable proxy for *current* replacement costs without these adjustments.
- 7.62 It is clear that the most important difference between a 'fresh' 2010 ODV and the Commission's proposed approach is a significant divergence in the *standard unit replacement costs* employed in the respective ODV calculation. Because standard replacement costs have increased at a rate

greater than CPI from 2004 to 2010, the Commission's proposed 'roll forward' approach is likely to produce a significantly *lower* value than a 'fresh' 2010 ODV based on current unit replacement costs and, by extension, lower regulated prices.

- 7.63 In summary, the additional reasons that the Commission provides for deciding against basing initial asset values on current replacement costs are unpersuasive.

Updating the Initial Values

- 7.64 The Commission contends in its Draft Reasons Paper that it would be 'fundamentally inconsistent' to undertake a 'new ODV' to establish initial asset values, but then to roll the RAB value forward 'without future ODVs'.⁴⁴ It is worth mentioning at the outset that Orion is comfortable – and in fact has consistently supported – periodic ODV resets.⁴⁵ In consequence, we would be happy for the Commission to set an initial asset valuation based on 2010 replacement costs and to reset that value at the outset of each subsequent regulatory period.
- 7.65 However, the Commission is wrong to suggest that it cannot reasonably 'lock in' an estimate of replacement costs as at 2010 and roll forward that value *without* subsequent resets. The extent to which the many potential variants of either methodology promotes the outcome of a workably competitive market depends ultimately upon *many factors*, including the treatment of depreciation, revaluations, and so on. The decision to 'lock in' or 'roll forward' the initial RAB is not determinative and can lead to very similar price outcomes in any event.
- 7.66 Indeed, depending upon the choice of depreciation profile, the regulated prices delivered by a roll-forward methodology and by an approach in which ODV values are periodically updated may be *very similar* and, in some circumstances, *identical*.⁴⁶ In other words, the distinction between the two approaches is neither as straightforward nor as crisp as the Draft Reasons Paper implies. It is therefore not correct for the Commission to

⁴⁴ Draft Reasons Paper, para 4.3.94

⁴⁵ Draft Reasons Paper, para 4.3.39

⁴⁶ Provided the rate of depreciation is sufficiently fast that the provider is able to set prices that recover its revenue requirement, myriad regulatory depreciation profiles (and hence price paths) are possible, including the price path that would apply if ODVs were periodically updated. See: The Allen Consulting Group, *Methodology for updating the regulatory value of electricity transmission assets*, Final report, August 2003 for the ACCC, p 40.

suggest that it would be 'fundamentally inconsistent' to estimate a new ODV to establish the initial RAB, but then to roll the RAB value forward without periodic ODV revaluations.

- 7.67 Finally, it is telling that the Commission's proposed use of disclosed asset values itself involves 'locking in' what was once an ODV valuation, without subsequent reapplication of that valuation principle. Although it seeks to characterise its proposed approach as an indexed historical cost (IHC) methodology – by suggesting that the 2004 ODV is a 'deemed' historical cost value⁴⁷ – this is demonstrably not the case. In fact, the Commission's approach involves updating an earlier ODV valuation by rolling that value forward without periodic ODV revaluations. In other words, if the Commission had in fact identified a 'fundamental inconsistency', that discovery would also preclude it from implementing its own proposal.

Summary

- 7.68 Nothing in the draft reasons paper detracts from the conclusion that the Commission is required by the new legislation to base the initial asset values for EDBs on an estimate of replacement costs as at 2010. Its discussion of long-term contracts is unhelpful and, when examined more closely, provides no support for its draft decision to use partially corrected disclosure values to set the initial RAB. The other reasons that it cites for eschewing a new ODV are similarly unconvincing. Finally, its contention that it would be 'fundamentally inconsistent' to undertake a 'new ODV' to establish initial asset values, but then to roll the RAB value forward 'without future ODVs', is wrong as a matter of economics.
- 7.69 By not making the necessary adjustments to the 2009 disclosures so as to ensure those values provide a reasonable estimate of replacement costs as at 2010, the Commission has not met the requirements of the section 52A purpose statement. The consequence is that a significant number of additional changes must be made to the 2004 ODV Handbook (by which the 2009 disclosure values have been derived) before the Commission can reasonably be said to have discharged its legislative obligations. We describe these changes below.

⁴⁷ Draft Reasons Paper, para 4.3.1

Implications for Initial Asset Values: A Materially Better Approach

- 7.70 Taking the 2009 disclosure value and making modest corrections does not produce a reasonable estimate of replacement costs as at 2010, which is the Commission's task, for the reasons set out above. To achieve that objective, the Commission must give effect to the changes set out in the PwC Handbook. Orion has had the opportunity to review those changes and agrees that they are needed in order to meet the requirement of the purpose statement.
- 7.71 First, the Commission must give effect to the following *methodological* changes to the 2004 Handbook, as described by PwC in its 2010 ODV Handbook (and summarised in the submission lodged by the ENA):
- 7.71.1 the proposed revisions to the replacement cost multipliers, including:
- (a) for cables laid in rugged or rocky terrain; and
 - (b) for cables laid in high density urban locations;
- 7.71.2 other proposed revisions to the ODV methodology, including:
- (a) updated provisions for depreciation which reflect current evidence of asset performance and modern equivalent assets;
 - (b) modifications to the 'significant scale of construction assumptions' included in the 2004 Handbook; and
 - (c) changes to the total asset life assumptions for a limited number of asset categories; and
- 7.71.3 changes to the initial asset values that sit *outside* the ODV methodology per se, including:
- (a) including easements at their current replacement costs, which is what an entrant would be forced to outlay to acquire those assets in a workably competitive market; and
 - (b) an allowance for working capital, which is a standard business requirement for an EDB.
- 7.72 Because the Commission's draft determination does not incorporate these changes, the 2004 ODVs do not accurately reflect replacement costs at

that time and, by extension, rolling forward those values in the manner proposed by the Commission cannot provide a reasonable proxy for *current* replacement costs. For this reason, the changes must *also be made under the Commission's preferred approach*, since they are needed to *properly* (rather than just 'partially') correct the 2004 ODVs.

- 7.73 It would also be materially better for the Commission to adopt up-to-date estimates of *unit replacement costs*, which form a critical *parameter* in the ODV methodology. In the absence of information to suggest that today's values are aberrant (in the sense that they are not likely to be reflective of standard unit replacement costs when the market is in long-run equilibrium), adopting today's estimates of unit replacement costs would be more likely to yield a more accurate initial RAB than adopting indexed estimates of what the replacement costs were six or more years ago.

Conclusion

- 7.74 The Commission's asset valuation IM must promote outcomes consistent with those produced in workably competitive markets, as prescribed in section 52A. The orthodox application of economic principles provides clear guidance to the Commission. Specifically, to produce an initial asset valuation that promotes a workably competitive market outcome it should determine an estimate of replacement costs *as at 2010*. However, there are various potential ways that the Commission might update that initial RAB over time that are potentially consistent with this benchmark.

- 7.75 The Commission's draft decision is to 'lock in' the 2009 disclosure values with some modest corrections and to 'roll forward' those values without subsequently revisiting them. It characterises its proposal as a 'deemed' historical cost approach, but it is not. Rather, the Commission is proposing to 'roll forward' earlier replacement cost estimates so as to produce a 'partially corrected' 2004 ODV. The reasoning underpinning the Commission's decision is unsound. In particular:

7.75.1 its discussion of long-term contracts is misguided and, when examined more closely, provides no support for its draft decision to use partially corrected 2004 values to set the initial RAB;

7.75.2 the other reasons that it cites for eschewing a new ODV are similarly unconvincing, *ie*:

- (a) its assertion that downward revaluations would reduce EDBs' incentives to innovate and invest are groundless and, even if

they are not, they can be readily addressed by 'locking in' the initial RAB and specifying appropriately defined prudent investment tests for capital expenditure;

- (b) its concerns that adopting a fresh 2010 ODV would lead to a "windfall gain" cannot be supported, given the absence of any information to suggest that today's standard replacement unit costs are in any way aberrational or unreflective of replacement costs when the market is in long-run equilibrium;
- (c) in any event, there are mechanisms that can be adopted to address any aberration that may subsequently be revealed, such as repeat ODVs, if future standard replacement unit costs vary too substantially from those used in the fresh 2010 ODV;

7.75.3 its contention that accuracy is not a meaningful objective when estimating an ODV because of the degree of subjectivity involved is untenable; and

7.75.4 its contention that it would be 'fundamentally inconsistent' to undertake a 'new ODV' to establish initial asset values, but then to roll the RAB value forward 'without future ODVs' is wrong as a matter of economics.

7.76 The potential result of these errors is that the Commission's draft decision may not promote an outcome consistent with those observed in workably competitive markets. At the very least, the draft decision ignores a materially better approach. Specifically, in Orion's view the Commission should give effect to the changes set out in the PwC Handbook so as to arrive at an accurate estimate of the ODV of EDBs' system fixed assets as at 2010. There are then a number of ways in which the Commission might update those initial values over time, with Orion's preference being periodic ODV resets.

PART 8: CUSTOMISED PRICE-QUALITY PATH

Summary

- 8.1 Orion has had the opportunity to review the submission on the customised price-quality path (CPP) input methodology prepared by the Electricity Networks Association (the ENA). We support the ENA submission on this matter in its entirety and adopt its conclusions as our own.
- 8.2 The Commission's CPP IM as currently drafted is unsatisfactory in many respects. The large number of recommendations contained in the ENA submission – all of which represent material improvements – highlight the significant work that must be done before the IM is fit for purpose. Our central concern is that the IM presently does not provide sufficient certainty of process or outcome, which is likely to make applying for a CPP an altogether too risky proposition for most businesses.
- 8.3 Below we elaborate upon some of the matters raised in the ENA's submission that are of particular concern to Orion.

Evaluation criteria

- 8.4 A business cannot be expected to lodge an application for a CPP unless it knows the criteria against which its proposal will be evaluated and, in particular, how it might be *modified* by the Commission. The purpose statement will not be promoted if the Commission springs unexpected surprises on applicants by evaluating proposals against undisclosed or insufficiently explained criteria or, worse, if it unilaterally replaces aspects of a proposal without sufficient basis.
- 8.5 The ENA's recommended changes to the Commission's evaluation criteria constitute material improvements in this respect. However, we believe it is possible to provide an even greater degree of certainty to prospective applicants. For example, the Farrier Swier report suggested that additional guidance should be provided to businesses, such as detailed explanations of what the Commission would expect from a prudent service provider in certain circumstances. Additional guidance on such matters can only serve to assist the regulatory process.

Transitioning back to a DPP

- 8.6 A business will be similarly reticent to lodge an application for a CPP if it does not know what will happen *when that price path expires*. Section 53X of the legislation states simply that a business reverts to the DPP and that the applicable starting prices are those that applied at the end of the CPP *unless at least 4 months before the end of the CPP the Commission advises that different starting prices must apply*. However, the legislation
- 8.6.1 does not make it clear whether the Commission is required to advise the business of the *actual starting prices to apply* at least 4 months before the CPP expires, or simply that the applicable starting prices will not be the existing prices;
 - 8.6.2 does not specify any criteria that the Commission is to apply when deciding whether to use existing prices or some alternative, i.e., whether a profitability calculation is required; and
 - 8.6.3 does not set out any methodology by which the Commission is to arrive at alternative starting prices.
- 8.7 In other words, the transitional provisions in the legislation are far from illuminating. It is therefore incumbent upon *the Commission* to provide clarity on these critical procedural points. Unfortunately, it has not. No guidance whatsoever is provided in the Draft Reasons Paper. This represents a significant shortcoming that must be addressed if the new arrangements are to function as intended.

Information disclosure requirements

- 8.8 The Commission continues in its Draft Reasons Paper to contend that expenditure category information for a CPP application should align with current or expected information disclosure requirements (IDRs) information to the extent practicable. Although we support an approach which is cost effective, it is worth drawing attention to two factors that appear to have received insufficient attention.
- 8.9 First, the Commission appears to be placing misplaced emphasis on the *existing IDRs*.¹ This overlooks the fact that these requirements *pre-date*

¹ For example, it comments that it has consulted on the appropriate expenditure categories in its Information Disclosure Discussion Paper in July 2009 (ID Discussion paper).

the new regime and were formulated for a different purpose. There is now a *new statutory purpose* for such requirements as set out in Section 53A, and the new legislation has *changed materially the role of IDRs*. The relevance of the existing IDRs (particularly insofar as they relate to CPPs) is therefore questionable.

8.10 To be clear, the Commission is *yet to produce* IDRs in the context of Part 4 that can be used to populate and assess a CPP application. Accordingly, although we support an approach which is cost effective, and aligns as closely as possible the IDRs between all of the regulatory mechanisms (subject to the observations set out below), the Commission must bear in mind that the IDRs for EDBs *are likely to change*.

8.11 Second, although we recognise and understand that the information requirements for CPPs would, in an ideal world, be in standard form containing consistent information, this is simply not practicable or achievable given the diversity that exists amongst EDBs. Put simply, we doubt that there can be a 'one size fits all' approach to information requirements for a CPP. The Commission seems to recognise this when it concludes that:

"It is not possible, nor desirable, for the Commission to specify in detail the nature of the assessment that it is likely to undertake during the 150 working day assessment period because it will depend heavily on the type of proposal it will receive".

8.12 Implicit in this statement is an acknowledgement that proposals are likely to differ from business to business, be circumstance dependent and entail unique features. It is consequently unrealistic to expect that proposals can comply with a standard form. For example, given the diversity in the size of the suppliers in New Zealand, the information that EDBs would collect to meet their individual Boards is likely to differ materially. The information that we work with is specific to the Orion business model and practices. Sometimes information will be available in the form requested by the Commission and sometimes it will not.²

8.13 In our view, what is called for is *flexibility*, so as to recognise the differences that exist amongst EDBs and the nature of a *Customised Price*

² For example, Orion has to seek exemption from a section of the current ID requirements as we do not collect information in the form required because it is not required by our business model. In other cases our base information must be worked on to put it in the form required.

Path that supports innovation as per the purpose statement. We urge the Commission to not underestimate the time, cost and effort associated with complying with standardised information requirements.³

Relationship with EA pricing methodologies

8.14 We re-iterate our concerns that the Commission's jurisdiction to set pricing methodologies will soon be transferred to the EA when the Electricity Industry Bill (EIB) passes into law (very likely to occur in the next two months). This transfer of jurisdiction raises considerable uncertainty for EDBs in relation to the pricing methodology to apply to the DPP and to CPPs, for the following reasons:

8.14.1 Once the power to set pricing methodologies is transferred to the EA (which will set pricing methodologies as part of the Electricity Industry Participation Code (Code)), an EDB will be obliged to comply with the EA's pricing methodologies. It is possible the EA may set pricing methodologies which do not comply with the requirements of Part 4 (or otherwise conflict with the pricing principles set out by the Commission in its draft information disclosure methodology).

8.14.2 The EIB transfers jurisdiction to the EA for setting pricing methodologies, but it is possible that the Commission may act inconsistently with the Code when exercising other powers under the Commerce Act which may relate to or affect EDBs' pricing (for example, a decision to approve a particular CPP). Although the Commission is obliged to have regard to the Code before exercising its powers under the Commerce Act 1986, it is not prevented from exercising powers which may (indirectly) relate to or affect pricing methodologies.

8.14.3 As Orion noted in its submission to the select committee on the EIB, inconsistencies between the two regulatory regimes may lead to an EDB being unable to recover all its costs or result in price shocks for

³ By way of indication, Orion has had to expend considerable time and effort to meet the new facets of the 2010 IDRs involving the breakdown of actual expenditure into the Commission's categories (schedule AM1) which were required for the first time. Although these information requirements are to be based on information which was deemed to be readily available within businesses substantial resources have been expended complying with the requirements.

a particular group of customers,⁴ and it is also conceivable that EDBs may end up in the uncomfortable position of having to comply with two conflicting pricing methodologies.

- 8.15 The Commission must ensure that the integrity of Part 4 is not undermined by any pricing methodology set by the EA (once the EIB comes into force), be it by inconsistency between the regimes or the two regulators (directly or indirectly) imposing differing requirements. For this reason we believe the Commission should in its initial final determination address each of the uncertainties identified in paragraph 8.14, above.

⁴ Orion New Zealand Limited, *Submission to the Finance and Expenditure Select Committee on the Electricity Industry Bill*, 17 March 2010.

PART 9: COMMENTS ON THE DRAFTING OF THE COMMISSION'S DRAFT DETERMINATION

- 9.1 As has been noted in the previous Parts of its submissions, Orion has concerns about the Commission's IMs and in particular the proposed IMs for asset valuation, cost of capital, CPPs and also the lack of an IM in relation to the starting price adjustments for DPPs. The approaches that Orion and the ENA (along with other EDBs) recommend to address these significant shortcomings in the Commission's proposals are substantial.
- 9.2 The nature and extent of the revisions and corrections that we believe are necessary to the Commission's draft determination in order to reflect Orion's and the ENA's recommendations are substantial. They go well beyond the minor drafting issues that we envisage the Commission contemplated parties commenting on as part of the Commission's invitation for marked-up comments on the draft determination.
- 9.3 Given that and the time constraints, Orion has not attempted to draft a new input methodology determination on the asset valuation and cost of capital IMs, but encourages the Commission to work with the Parliamentary Counsel Office to draft a new input methodology determination that reflects and adopts the points put forward by Orion in its submissions.
- 9.4 We will of course be pleased to provide further comment when the Commission has produced a revised draft determination.

