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Network Performance Branch  
Commerce Commission  
Wellington

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### PRE-WORKSHOP SUBMISSION ON EMERGING VIEWS

1. Orion New Zealand Limited (**Orion**) welcomes the opportunity to make a submission on several matters arising from the Commerce Commission's (**Commission's**) Input Methodologies (Electricity Distribution) Emerging Views Paper (**EV Paper**).<sup>1</sup> Consistent with the Commission's instructions, we have limited our submission to those matters of principal concern to Orion that we would like to explore at the workshop on 24-26 February. We look forward to making further submissions following the workshop.
2. The EV Paper is a positive contribution to the consultation process. We now see the workshops as enabling further debate and discussion, and in particular an opportunity for the Commission to explain why it has not accepted many of the submissions put to it at its conference on the Input Methodologies Discussion Paper<sup>2</sup> (**IM Conference**). Indeed, the conclusions in the EV Paper in key areas are drawn largely without reference to the IM Conference or parties' submissions. Accordingly, it is difficult to get a gauge on the Commission's view of the arguments put to it in that process.
3. The workshops should be structured to enable this discussion to occur, rather than focussed on narrow questions relating to the details of the

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<sup>1</sup> Commerce Commission, *Input Methodologies (Electricity Distribution) Emerging Views Paper*, 23 December 2009.

<sup>2</sup> On 14 and 15 September 2009, the Commission held a conference on the development of input methodologies for application or potential application in determining default and/or customised price paths for certain services provided by electricity lines and gas pipelines, and information disclosure in respect of airports. See: Commerce Commission, *Input Methodologies Discussion Paper*.

Commission's new preferred options. Doing otherwise risks jeopardising the efficacy of the consultation process, and may result in the premature dismissal of options that, in our view, have not yet been properly evaluated by the Commission and ultimately may better meet the legislative purpose statement.

4. The remainder of this submission is structured as follows:
  - 4.1 section 1 identifies some of the concerns that we have with the Commission's new preferred approach to establishing the initial regulatory asset base (**RAB**);
  - 4.2 section 2 summarises our reactions to the Commission's emerging views on the proposed approach to rolling forward the RAB;
  - 4.3 section 3 sets out our view on the Commission's emerging view on cost allocation methodology; and
  - 4.4 section 4 contains some brief remarks on the Commission's emerging view in relation to regulatory rules and processes under a customised price-quality path (**CPP**).

#### **1. Initial RAB**

5. The establishment of the initial RAB is unquestionably one of the most significant steps in the introduction of the new regulatory arrangements for electricity lines businesses (**ELBs**). Decisions on matters such as the roll-forward approach and the cost of capital will unquestionably have an important effect on investment incentives. However, the degree of commitment (or lack thereof, as the case may be) on the part of the Commission to follow a principled, transparent approach to setting the initial RAB is also likely to have a very significant effect on incentives to invest and innovate.<sup>3</sup>
6. In the following sections, we summarise the Commission's new preferred approach, and set out a number of concerns that we have with that proposal. We then re-iterate an alternative that we believe the Commission is yet to properly consider; namely, a new ODV as at 2010, with a transparent adjustment mechanism, such as that expressly

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<sup>3</sup> In other words, we do not agree with the Commission's contention that it is the approach to rolling forward the RAB that has a greater effect on investment incentives than the approach to setting the initial RAB. See EV Paper, para C30.

permitted by s53P8(a), used (if necessary) to insulate consumers or lines businesses (as the case may be) from the effects of 'rate shock'.

*The Commission's Preferred Approach*

7. The Commission's EV Paper considers two alternatives to its original proposal to set the opening RAB by using the 2004 optimised deprival value (**ODV**) as a 'base valuation' and rolling it forward, adjusting for consumer price inflation, acquisitions, disposals and depreciation, specifically:
  - 7.1 a new ODV as at 2010, based on the application of the hypothetical new entrant (**HNE**) concept as at the starting date for the new Part 4 regulatory regime; and
  - 7.2 a value based on the 2009 information disclosure accounts for each business, ie, the 2004 ODV adjusted for new assets valued at indexed unit costs, disposals and depreciation.
8. The Commission states that it does not favour estimating a new ODV as at 2010, because it considers arguments that were based on the application of the HNE concept to be 'unpersuasive'.<sup>4</sup> In particular, it claims that it cannot be confident that such a value would be consistent with long-run equilibrium in a workably competitive market.<sup>5</sup> The Commission also appears to believe that a 2010 ODV would result in significant price increases for consumers although, for the reasons set out below, the foundation of that belief is unclear.<sup>6</sup> In contrast, the Commission considers that an initial RAB sourced from the 2009 disclosure accounts may be an appropriate approach, since:
  - 8.1 it believes that it would "balance" the interests of consumers and suppliers;<sup>7</sup>
  - 8.2 it is said to be a simple way of ensuring that the opening RAB is at least as high as reasonable investor expectations;<sup>8</sup> and

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<sup>4</sup> EV Paper, p.35.

<sup>5</sup> EV Paper, para C20.

<sup>6</sup> EV Paper, para C33.

<sup>7</sup> The Commission states that setting an initial RAB value that is consistent with the long-term benefit of consumers suggests setting a lower rather than a higher RAB value, but that the value should not be so low that it is detrimental to investment incentives, since this would not be in the interests of consumers. See: EV Paper, paras C29-30.

<sup>8</sup> EV Paper, para C33.

8.3 it would ensure that there would not be any 'further upward rate shocks' following the imposition of the new regulatory regime.<sup>9</sup>

9. The Commission also indicates that it may be worth correcting the 2004 ODVs for quantity, characterisation, age and estimation errors, or omissions from the asset register that would now meet a 'used and useful' test. We note, however, that the Commission has not undertaken to revisit whether the methodology *itself* was robust at the time, including whether the unit costs or optimization assumptions applied to particular assets were appropriate.

#### *Concerns with the Commission's Preferred Approach*

10. We are concerned with a number of aspects of the Commission's preferred approach to establishing the initial asset value. First, although the Commission's new preferred approach is presented in the EV Paper as an alternative to the valuation methodology that it initially proposed, there is in fact little difference between them. The former amounts to a superficial repackaging of the latter. Most critically, both continue to be linked to the 2004 ODV – a valuation with which lines businesses have continued to express serious reservations.<sup>10</sup>
11. Second, the Commission emphasises repeatedly in its EV Paper the importance of regulating in a manner that is consistent with the reasonable expectations of investors. This consideration has not been particularly prominent throughout the consultation process to date, but is given substantial weight in the EV Paper. We agree that respecting investors' expectations is important, since it goes to the heart of businesses' incentives to invest and innovate, and so to s52A(1)(b) of the regulatory purpose statement. However, the Commission has not accurately represented those expectations in its EV Paper.
12. The discussion of investor expectations focuses on the fact that the 2009 valuation is 'already in the public domain',<sup>11</sup> and some brief remarks made by a recent entrant about the relevance of that value. Neither is particularly relevant. The fact that the 2004 ODV and its rolled forward 2009 information disclosure equivalent ODV is publicly available is not decisive, particularly in light of the well-publicised deficiencies in the underlying 2004 valuation – deficiencies which become more pronounced

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<sup>9</sup> EV Paper, para C33.

<sup>10</sup> For the reasons set out below, the Commission's concession to correct errors and omissions that meet a 'used and useful' test fall well short of addressing these shortcomings.

<sup>11</sup> EV Paper, para C33.

when that ODV forms the foundation of a price path, as opposed to a reference point for comparison purposes in the context of information disclosure. Moreover, the highlighted passage attributed to the CEO of Wellington Electricity<sup>12</sup> appears to be lamenting the fact that the 2004 ODV was the *only reference point* for valuation purposes, not that it is a more appropriate starting point than a current ODV. We look forward to discussing at the workshop the Commission's reasoning regarding the linkage between investor expectations and the 2009 disclosed values.

13. Nowhere in the EV Paper has the Commission acknowledged on numerous occasions that it assured lines businesses that the imposition of control would prompt it to address the short-cuts taken producing a valuation for disclosure purposes<sup>13</sup>. Orion has placed a large volume of material before the Commission on this point,<sup>14</sup> as have other EDBs. The regulatory compact that existed between the Commission and lines businesses on this point is the most germane factor in determining the reasonable expectations of investors, so we are eager to understand the reasons the Commission now considers it appropriate to overlook its earlier assurances to the industry.
14. Third, the well-documented shortcomings with the 2004 ODV meant that Orion's previously indicated<sup>15</sup> preparedness to accept an initial RAB linked to such a valuation is contingent upon these problems being addressed prior to it being employed. The Commission's concession to correct errors and omissions that meet a 'used and useful' test is a step in the right direction, but nonetheless falls well short of addressing the many methodological shortcomings that Orion has repeatedly highlighted. If the Commission is not prepared to revisit matters of substance, such as the robustness and accuracy of the applied unit cost estimates, this weighs heavily in favour of estimating an updated, methodologically sound ODV (which may be simpler and more cost-effective than addressing the problems with the 2004 ODV in any event<sup>16</sup>).

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<sup>12</sup> EV Paper, para C38

<sup>13</sup> For example: Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Resetting the Price Path Threshold*, Discussion Paper, 30 May 2003, paragraphs [14] and [7.12]; and Commerce Commission, *Regulation of Electricity Lines Businesses – A Companion Report to the Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses*, 31 August 2004, page 6

<sup>14</sup> See most recently: Orion New Zealand Limited, *Submission on Reset of the Default Price-Quality Path for Electricity Distribution Businesses*, 17 July 2009, p.6.

<sup>15</sup> Orion New Zealand Limited, *Submission on Input Methodologies Discussion Paper*, 13 August 2009

<sup>16</sup> For example, Orion is aware that the Electricity Networks Association has commissioned PwC and SKM to develop jointly a 2010 ODV handbook, which should go some way to expediting

15. As Orion has noted previously<sup>17</sup> the statutory context demands an accurate assessment of asset values, not simply a 'best guess'. The reference in s53P(3) to "prices based on current and projected profitability" requires the Commission to develop an input methodology which accurately assesses asset values. The objective of s53P(3) will not be achieved if a second best approach to valuation is utilised.
16. Finally, and perhaps most crucially, some of the most decisive factors that underpin the Commission's new preferred approach are not made explicit in the EV Paper and, in some instances, seem to turn on empirical analysis that has not yet been undertaken. Most notably, the decision seems to be motivated in large part by the perceived need to protect consumers (but, unusually, not businesses) from 'rate shock'. Specifically, the Commission states that its preferred approach would:<sup>18</sup>

*'...ensure that there would not be any further upward rate shocks following the imposition of regulation, as may be generated by a new replacement cost-based valuation.'*

17. In other words, the Commission assumes that a 2010 ODV valuation will give rise to 'rate shock' issues, which it interprets as being limited to *higher* prices, but that such issues will not arise if a 2009 disclosure asset valuation is adopted. This appears to form a critical reason for preferring the 2009 approach. We acknowledge that the potential price consequences (both upward and downward) of different asset valuation approaches are relevant factor for the Commission to consider. However, we do not understand how the Commission has reached the view that a 2010 ODV will give rise to unacceptable rate shock, but that its preferred option would not, since:

17.1 there is not a strong connection between existing prices and disclosed asset values, and so it is not yet apparent that 'linking' the two would result in the smooth price transition that is envisaged – it is likely (and perhaps inevitable) that the preferred option will give rise to significant price increases for some companies and decreases for others;

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the formulation of revised 2010 estimates. Moreover, given that there is an additional six months to finalise input methodologies, there is ample time for the Commission to undertake a robust, comprehensive ODV reset.

<sup>17</sup> See for example: Orion New Zealand Limited, *Submission on Reset of the Default Price-Quality Path for Electricity Distribution Businesses*, 17 July 2009.

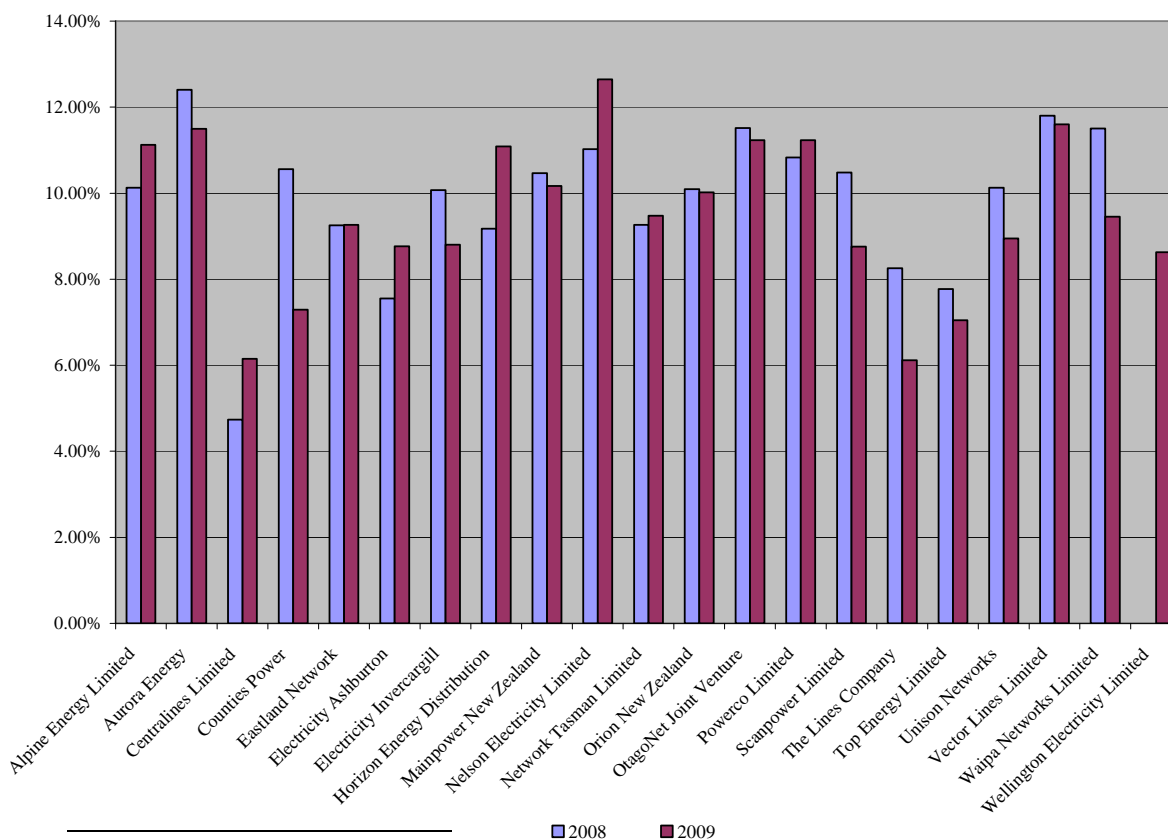
<sup>18</sup> EV Paper, para C33.

17.2 there is not yet any way of knowing (unless the Commission has conducted its own analysis) the extent to which employing a new ODV as at 2010 would result in greater 'rate shock' (either positive or negative) than using the latest disclosed values; and

17.3 the initial RAB ultimately is only one determinant of prices, so there is no way of knowing whether any increase (decreased) in the RAB will deliver higher (lower) prices, *regardless* of how it is set, ie, whether a 2010 ODV or a 2009 disclosure value is used.

18. Put simply, the application of *any initial asset value*<sup>19</sup> will give rise to price changes across the industry, with examples of prices needing to change both up and down. This is highlighted by the wide range of disclosed ROIs on 2009 disclosed asset values displayed in Chart 1 below (which range from 6% to 12%), which indicates that any price adjustments are unlikely to be unidirectional. The Commission will need to address 'rate shock' under any asset valuation approach – it is not a consideration that arises solely from approaches based on a 2010 ODV.

**Chart 1. Disclosed Returns on Investment, 2008-2009**



<sup>19</sup> Other than an approach that simply underwrites current prices for each lines business, which has not been discussed or proposed by the Commission.

19. There is a wide range of ROIs in Chart 1. In the absence of a very wide range of acceptable WACC figures, logic tells us an ROI of 6% and ROI of 12% cannot co-exist under the new input methodologies without some adjustments. These adjustments will be required regardless of the valuation methodology adopted: the use of 2009 disclosed valuations will not avoid 'rate shock'. The above chart also highlights the difficulty of assuming (as the Commission appears to do in its EV Paper) that a methodology can be chosen which results in few, if any, price adjustments.
20. The inevitability of price changes means the Commission's 'rate shock' justification for favouring the 2009 disclosure values is unsound. It is not appropriate to dismiss a valuation methodology based on unsubstantiated assumptions about the potential impacts on price, particularly when the Act makes express provisions for addressing price consequences in a transparent manner. It is all the more unsound when at this early stage those price outcomes are uncertain, eg, the Commission is yet to come to a view on WACC and many other key determinants of prices. In our view, the Commission must reconsider this matter, and explain at the workshops its reasoning for assuming that a 2009 ODV will not result in 'price shock' but any other approach will. As a matter of principle, any price adjustments should be dealt with transparently once the consequences of the chosen valuation methodology become clear.
21. Moreover, because price changes are an inevitable consequence of a workable competition standard regardless of the asset valuation approach employed, the Commission must turn its mind to how best to manage them. For example, it would be unacceptable for the Commission to deal with 'rate shock' by, say, making arbitrary adjustments to the initial RAB, the regulatory WACC or any of the other 'building blocks'. What is needed is a transparent, principled approach for dealing with such matters. Accordingly, it would be helpful if at the workshop the Commission was able to provide its thoughts on:
  - 21.1 whether it intends to approach such rate shock issues symmetrically, ie, if price reductions are to be contemplated, will these be treated in the same way as price increases? If not, why not?;<sup>20</sup>

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<sup>20</sup> We note, for example, that a 10 per cent price reduction may affect adversely a lines business more significantly (eg, in terms of its effect on incentives to invest and innovate) than a 10 per cent price increase may affect consumers, given that distribution charges represent only a modest fraction of final electricity retail prices.

- 21.2 what size of price change (both up and down) might require ‘phasing in’ using, say, the adjustment mechanism provided in s53P(8)(a), which extends to the Commission the discretion to ‘set alternative rates of change ... to minimise price shocks’?; and
- 21.3 if there are to be ‘phased in’ price changes (using the discretion in s53P(8)(a)), will these be on an NPV neutral basis, or by means of a ‘glide path’ that means a transfer in value between the company and its consumers (one way or another)?
22. Orion also would like the opportunity to discuss the following statement made by the Commission in its EV Paper:<sup>21</sup>

*‘Some submitters favoured a new valuation on the basis that the latest information is the best information. However, the Commission notes that replacement cost valuations simply provide a way of placing a value on assets at a particular point in time when there are no other valuations available (or of providing guidance on whether available valuations are likely to be reasonable). Updating a previous value simply because the inputs into that calculation have changed will not result in a valuation that is more consistent with the outcomes produced in competitive markets. Nor would adjustments necessarily result in a valuation that would necessarily more accurately reflect investor expectations (particularly given that the results of such a valuation would be uncertain).’*

23. The basis for the contention that replacement cost valuations ‘simply provide a way of placing a value on assets at a point in time when there are no other valuations available’ is unclear. The claim seems to be that replacement cost valuations are viewed as a ‘last resort’, when there is no other alternative available. We are eager to discuss with the Commission at the workshop the basis upon which it has reached that conclusion since, in our view; the economic bona fides of the ODV methodology are well established. As NERA and PwC explain:<sup>22</sup>

*‘Notwithstanding their role as a ‘point of departure’ in some circumstances, replacement cost valuations have been adopted without adjustment in a large number of cases in Australia. **This reflects the widely accepted principle that such valuations are consistent with those observed in effectively competitive markets, and that the outcomes of competitive markets provide a useful guidepost for regulation.**’ (emphasis added)*

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<sup>21</sup> EV Paper, para C34.

<sup>22</sup> NERA & PwC, *Initial Value of Regulatory Assets – the Australian Experience, A Report for Orion and Powerco*, 6 December 2009, p.2.

24. The Commission's view that updating a valuation to reflect more recent information on inputs will not be more consistent with competitive market outcomes, or with investor expectations should also be discussed. Investor expectations can certainly reflect a belief that a particular methodology will be used, even if the outcome is uncertain. Long-term contracts struck in competitive markets often contain price-escalation clauses linked to published indices, or clauses that require prices to be periodically renegotiated in line with market conditions. Contracting parties may not be able to foresee the precise effects of such clauses beforehand, but the *methodology* that will be used is known and accepted.
25. In a similar fashion, lines businesses had a reasonable expectation that the many problems with the 2004 ODV would be addressed if control was imposed, even though they may not have been able to foresee the precise value, or the exact price consequences. As noted above (and in previous submissions), this expectation was repeatedly reinforced by the Commission over the years. We therefore submit that undertaking a 2010 ODV *would* more accurately reflect investor expectations in that it would address those shortcomings (and potentially more effectively than making retrospective corrections to the 2004 ODVs), whilst being consistent with a workably competitive market outcome.
26. The workshops should be structured to enable a detailed discussion of how the "investor expectations" concept should be employed to discriminate between competing methodologies and how it relates to the s52A purpose statement.
27. The Commission's discussion of long-run equilibrium is also difficult to understand. As noted above, one of the primary reasons that the Commission provided for not favouring a 2010 ODV was that it could not be confident that such a value would be consistent with 'long-run equilibrium' in a workably competitive market.<sup>23</sup> Even if this is true, it does not necessarily mean that the Commission should favour one ODV over the other, because:
- 27.1 it can be no more confident that the 2004 ODV reflects long-run equilibrium in a competitive market, yet it forms the basis for its preferred option;
- 27.2 it effectively entrenches the various shortcomings in the 2004 ODVs, which Orion and other businesses have repeatedly emphasised; and

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<sup>23</sup> EV Paper, para C20.

- 27.3 it potentially rules out the possibility of a new replacement cost valuation ever being considered, since the Commission would always be free to exercise its 'regulatory discretion',<sup>24</sup> and claim that it 'cannot be certain' that a new value is consistent with long-run equilibrium.
28. Overall, we are not persuaded that the reasons provided in the EV Paper provide a strong foundation for the approach that is proposed. We encourage the Commission to be transparent in the coming workshop about the reasons for its preliminary decision, so that we can understand why it has dismissed what appear to be reasonable alternatives. At present, there continues to be a strong case for instituting a new ODV as at 2010, as we explain below.

*Alternative Approach: a 2010 ODV*

29. Orion considers that the option of undertaking a new ODV as at 2010 should remain on the table. A 2010 ODV is more consistent with the statutory objectives than the approach outlined in the EV Paper and with the concept of "investor expectations". In particular, a 2010 ODV would:
- 29.1 be consistent with workably competitive market outcomes, and the related HNE concept,<sup>25</sup>
- 29.2 address the many deficiencies with the 2004 ODVs – potentially in a far more effective way than seeking to fix those problems retrospectively for each business;
- 29.3 be consistent with the long-standing understanding between the Commission and lines companies that the introduction of control would prompt the Commission to fix the problems with the 2004 ODVs (and so be consistent with investor expectations); and
- 29.4 promote incentives to invest and innovate by engendering certainty and confidence in the regulatory framework, and ultimately be in the long-term interests of customers.
30. We know of no basis for concluding at this stage that implementing a 2010 ODV would not meet the requirements of the legislative purpose

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<sup>24</sup> EV Paper, para C21.

<sup>25</sup> As noted above, the fact that the Commission 'cannot be confident' that a 2010 ODV would represent a 'long-run equilibrium' outcome is no reason for favouring the 2004 ODV, which presumably is characterised by the same degree of uncertainty.

statement. Nor does the Commission's EV Paper give any reasons beyond its assertion that a 2010 ODV would be inherently uncertain and that such a value would not necessarily reflect long-run equilibrium conditions in a workably competitive market. These reasons are unpersuasive.

31. Nonetheless, if the Commission remains unconvinced that a 2010 ODV should form the initial RAB<sup>26</sup> it should, at a *minimum*, undertake to address the many shortcomings with the 2004 estimate. As noted above, simply correcting errors and omissions that meet a 'used and useful' test falls well short of addressing the many *methodological* shortcomings that Orion has repeatedly highlighted. In particular, the Commission should undertake to reconsider the robustness of the applied unit cost *estimates*, which were inappropriate and substantially undervalued Orion's assets.
32. We recognise that there are likely to be challenges associated with correcting the 2004 ODVs, which were developed in a different statutory context and with numerous discrepancies and inconsistencies. For example, correcting the "Q" in our 2004 ODV would not be easy because, although we can identify some particular or significant data capture projects, in most cases asset records are simply corrected, and the incorrect data is overwritten or deleted (and thereafter there is no record of the change). Our information is improving all the time, and every day there are small improvements to our asset data records.
33. Recorded quantities change from valuation to valuation for a number of reasons, and it can be hard to identify the reasons for such changes. Changes come about from additions, removals, found assets, correction of errors and updated estimates (for those assets where quantities are based on statistical estimates). While all these factors affect quantities, it can be difficult to distinguish between them, for example:
  - 33.1 Asset removals are indistinguishable from quantity reduction corrections (where recorded assets are found no longer to exist).
  - 33.2 Installation of old assets (eg, where a transformer is reused and its original age is preserved) are indistinguishable from found assets.
  - 33.3 Many assets do not (and can not) carry an enduring ID number (eg, line and cable segments). New ID numbers are created when old conductor segments are split up during network configuration changes – a comparison of assets currently recorded and installed

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<sup>26</sup> Recognising that the reasons that it has articulated to date are not persuasive.

before the valuation date will show many assets (with ID numbers) that appear to be “found” assets, but are actually in the valuation under different ID numbers.

- 33.4 Age corrections (within a particular class of asset) show as a reduced number of assets of one age, and an increase in numbers of another age – these changes are indistinguishable from found assets and quantity reduction corrections.
34. In addition, as we have indicated in a number of submissions, the unit value assigned to cable costs were a primary area of concern for us and, in the build up to the 2004 ODV, Orion (and others) made several submissions on the topic. The unit costs across the country and over the period that submissions were made varied significantly.<sup>27</sup> It was clear that each distributor is exposed to different market pressures and that these pressures can change reasonably quickly. We did not (and still do not) consider that the 2004 handbook adequately reflected Orion’s costs and reflected an appropriate valuation of our assets. We are concerned that after six years it will be very time consuming, difficult and costly for us and the Commission to revisit this topic, particularly as we will not have any access to additional information that might help us resolve some of the variations
35. To be clear, by highlighting these complexities, we are not suggesting that the Commission should not undertake such an exercise, or that Orion would be a reluctant participant. Indeed, if the Commission is not prepared to undertake a 2010 ODV, then we believe that such a process *should* be undertaken to ensure the integrity of the initial RABs, however complex. Rather, what these challenges illustrate is that it may be more efficient and cost effective (and thus more closely accord with the objects of Part 4) to estimate a 2010 ODV at a particular point in time, than to seek to track changes over a prolonged period.
36. In this respect, we are aware ENA has commissioned PwC and SKM to develop a 2010 ODV handbook, and we note the six month extension now gives enough time for this exercise to be properly conducted. In our view,

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<sup>27</sup> A significant issue in this regard is that nearly all our capital work is project-based and priced by competitive tender. This does not readily provide information on which to clearly assess the unit replacement costs for individual components as required by the ODV methodology, and some degree of subjectivity will be required. To establish individual unit costs we approach contractors for a cost breakdown for a hypothetical set of construction contracts which allow us to assess the costs across our network. We have found that the costs vary considerably over time (the most significant factors being the exchange rates and metal prices), and in relation to the project assumptions (eg, trenching in roads or berms, the number and size of trees, traffic management and restricted working hours requirements).

the ENA's project to establish a new valuation handbook with a set of updated replacement costs (at 2010), based on a clearly defined set of parameters (which represent modern replacement configurations), together with an appropriate range of multipliers to reflect local conditions would provide a much more robust method of correcting deficiencies in the 2004 valuation.

37. Finally, there are no assets disclosed under the electricity disclosure requirements that should be excluded from the initial RAB value. However, there are assets attributable to lines businesses that are *not* disclosed and should be included in the RAB, including:

37.1 system and non system fixed assets attributable to the regulated service, including land and easements as well as net working capital;

37.2 assets which were optimised out or subject to EV adjustments which are in use and are required to meet supply requirements;

37.3 there is some debate regarding the boundary between system fixed assets and non-system fixed assets. If valuation methods differ for the two categories, this debate may need to be revisited; and

37.4 many assets are included in the RAB for which there are not assigned standard values.

38. In the following sections we summarise our initial reactions to the Commission's emerging views on the roll-forward approach, cost allocation and rules and processes under a CPP. Although important in their own right, in our view these matters are of secondary importance to the approach taken to establishing the initial RAB. For this reason, our submissions on these matters are more succinct than on the initial RAB, and in some cases involve recommending that further consideration be deferred for the time being.

## **2. RAB Roll Forward**

39. The Commission will recall that Orion has historically supported the use of indexed historic cost (IHC) as a mechanism to roll- forward the RAB between ODV revaluations.<sup>28</sup> However, at the outset of this particular

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<sup>28</sup> Orion New Zealand Limited, *Submission on Methodology for Rolling Forward the Regulatory Asset Base for System Fixed Assets*, 8 May 2006.

consultation process we did *not* support the Commission's proposal<sup>29</sup> to use an IHC approach, and instead favoured an un-indexed roll-forward approach (depreciated historic cost approach or '**DHC**'). It was our view that a DHC approach would reduce commercial and regulatory risks for lines businesses, therefore providing more certainty and better promoting the objective of the Act. Following the input methodologies conference we reiterated our preference for a principled and coherent package:<sup>30</sup>

*"We continue to hold the view that there is good reason to begin the new regulatory period with an up-to-date 2010 ODV that is then rolled forward using an indexed historic cost (**IHC**) approach, since this will best reflect the costs faced by a hypothetical new entrant (**HNE**) in a workably competitive market.*

*We would also support a principles-based ODV handbook and an approach that permits the use of independent valuers to assess the replacement value of assets based on local conditions – as opposed to striving for national consistency merely to allow greater comparability in the context of the information disclosure regime.*

*Consistent with the workable competition standard, we believe that a coherent regulatory package based on the HNE principle is properly supported by an up to date ODV, roll forward based using an IHC approach, a tax expense approach (which is simple to implement and consistent with a low cost DPP) and a cost allocation methodology based on ACAM. The Commission could also consider ODV updates on a regular basis say every 5 or 10 years<sup>31</sup>.*

*Such a regulatory design, when taken as a whole, in our view best delivers against the workable competition standard and the criteria in s 52A. If various elements are removed or altered, however, such a regulatory design may fall short of the workable competition standard, and for this reason we urge the Commission to consider our proposal not as a variable mix of components but as a principled and coherent package."*

40. As indicated in our previous cross-submission, and for reasons we explain below, we do not consider the roll forward can be considered in isolation from the other elements of regulatory package and in particular choices made around the RAB. Ultimately the global outcome must be tested against the s52A purpose statement.

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<sup>29</sup> Input methodologies Discussion paper para 11.88

<sup>30</sup> Orion New Zealand Limited *Post conference cross-submission on input methodologies*, 15 October 2009 para's 4 to 7.

<sup>31</sup> The use of an ODV - based approach also lessens the need for any prudency reviews.

41. The Commission's revised approach to regulatory depreciation, which contemplates accelerated depreciation in certain circumstances, goes some way to reducing those concerns (although does not necessarily eliminate them). If the Commission also was willing to meet lines businesses' expectations by addressing the problems with the 2004 ODVs – preferably by undertaking a 2010 ODV – we would then most likely be prepared to accept an indexed roll-forward approach.
42. However, if the Commission is minded to persevere with its preferred option to establishing the initial RAB, which does not address the many problems with the 2004 ODVs, and involves renegeing on its commitment to do so, then we would need to reconsider this position. The uncertainty resulting from repeated changes to the regulatory scheme tells strongly in favour of preferring upfront cashflow, particularly where investment is required in the near-term. A decision by the Commission to ignore its earlier assurances and opt for 2004 would further increase this uncertainty. In any event, we are eager to discuss in more detail at the workshop the circumstances in which the Commission will consider departing from straight-line depreciation.

### **3. Cost Allocation**

43. Orion 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 large scale unregulated activities. Any involvement is at a governance level with any directors' fees received attributed to the lines business. Consequently, our primary concern is that we are not forced to expend unnecessary time and expense complying with a cost allocation methodology, which delivers little or no benefit.
44. Orion's firm expectation is that our unregulated activities would not be sufficiently material to justify mandated compliance with a cost allocation methodology. Indeed, 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 opex and 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.
45. In our view, spending excessive amounts of time developing and applying a prescriptive set of allocation rules for costs that are not material is not justified. This also accords with the statutory warning that any input

methodology must not unduly deter investment by a regulated firm in the provision of other goods or services: see s52T(3).

46. For these reasons we tentatively support the 'light-handed' principles-based approach suggested by the Commission, in which businesses are free (within reason) to adopt their own definitions for cost categories and allocators. However, we do not consider that it is necessary to develop a cost allocation handbook – clearly articulated principles should suffice. We also support the introduction of a materiality threshold defined in such a way as to ensure that unregulated activities that are peripheral to core regulated businesses do not necessitate costly and time-consuming compliance with an FDC methodology. Requiring across-the-board compliance with a complex and rigorous cost allocation methodology will not further the statutory objectives of Part 4 and ultimately risks infringing s52T(3).
47. Unfortunately, it is unclear whether the Commission's proposed screening mechanism will adequately distinguish between unregulated activities that are peripheral and core regulated activities. There is some uncertainty around its definition of 'shared costs', and consequently the manner in which the threshold will operate. For example, the Commission suggests in Figure D1 that if 'shared operational costs are more than y% of total operational costs' a supplier may attribute all shared operational costs to the regulated business unit. Elsewhere in the EV Paper, it describes 'shared costs' as 'costs that are not directly attributable', and that 'shall be allocated using a cost allocator based on reasonable causal factors unless the CAMSC<sup>32</sup> suggests otherwise'.<sup>33</sup>
48. What we are unsure about is how the proposed materiality threshold would address the following types of scenario:
  - 48.1 suppose that a manager oversees a regulated business and a much smaller unregulated business, such that her \$100,000 p.a. salary is 'shared' between them; and
  - 48.2 suppose that 95% of her time is devoted to the regulated business, and only 5% to the unregulated business or, put another way, suppose that \$95,000 p.a. could reasonably be 'allocated' (or, potentially, 'directly attributed') to the regulated business, and \$5,000 p.a. to the unregulated business.

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<sup>32</sup> Cost allocation methodology screening criteria.

<sup>33</sup> EV Paper, Table D2.

49. In these circumstances, it is not clear how the screening criteria described in the EV Paper would treat that managerial cost. In particular, it is not apparent to us what, if anything, would constitute the 'shared cost' for the purpose of the calculation, for example:

49.1 would the \$100,000 p.a. cost be considered to be 'directly attributable' and hence not require the application of the cost allocation methodology (since it is not a 'shared cost')?; or

49.2 would the entire \$100,000 p.a. be considered a 'shared cost' for the purposes of determining whether 'shared operational costs are more than y% of total operational costs'?; or

49.3 would only the \$5,000 p.a. share allocated to the unregulated business be included in the calculation of shared operational costs as a proportion of total operational costs?

50. The first and third possibilities listed above would go some way to ensuring that peripheral unregulated operations do not necessitate compliance with an unnecessary allocation methodology. However, the second interpretation, in which the entire \$100,000 p.a. is included in the calculation, most likely would not. Such an approach overlooks the fact that only a very small proportion of the managerial cost can be attributed or allocated to the unregulated business, and risks imposing unnecessarily a FDC methodology. In consequence, we are eager to hear at the workshop the Commission's thoughts on precisely how it envisages implementing its materiality threshold in these types of scenarios.

51. Orion is also concerned that the Commission's discussion of cost allocation in its EV Paper does not address a number of the points that were raised at the IM Conference, and in parties' submissions. For example, in our cross-submission following the IM Conference we explained that, over time in a workably competitive market, a company that is able to obtain economies of scope by making investments in other activities will benefit from higher profits.<sup>34</sup> In time, a rival may be able to also attain those scope economies, so that those efficiencies are passed through to customers. However, 'first movers' will benefit from higher profits in the interim and, in some instances rivals will be unable to catch up, allowing the retention of profits in perpetuity.

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<sup>34</sup> Orion New Zealand Limited, *Post-Conference Cross Submission on Input Methodologies*, 15 October 2009, para 48.

52. More specifically, we explained that the long-term workably competitive market outcome will be determined by:
  - 52.1 whether the synergy in question is 'overwhelming', such that all businesses can be expected to restructure so as to achieve it; and
  - 52.2 the length of time that other businesses can be expected to take to replicate that synergy, with attendant effects on prices.
53. In consequence, we submitted that a potential weakness in the Commission's proposed approach to establishing materiality is that when unregulated activities result in a material level of common (or 'shared costs', however defined) costs and unregulated revenue, no consideration is then given to whether:
  - 53.1 the unregulated activity in question involves an overwhelming synergy that is expected to become widespread in the industry; or
  - 53.2 whether it represents a bespoke activity that is unlikely to be replicated on a wide-scale.
54. This distinction is important because, in a workably competitive market, only the former would be expected to translate into lower prices for the 'primary' activity for the reasons described above. In consequence, investments in bespoke or 'idiosyncratic' investment activities that are unlikely to become commonplace in the lines sector should not necessitate the imposition of a FDC methodology.
55. For these reasons, we suggested that the Commission consider adding an additional step to its methodology. Specifically, if the materiality threshold (however defined) is met, before contemplating any departure from ACAM, the Commission could be required to also satisfy itself that the activity in question is likely to become widespread in the industry. If it is not, then:
  - 55.1 a workably competitive market outcome is unlikely to involve those economies of scope being shared with the consumers of the regulated service; and
  - 55.2 there is no cause to deviate from ACAM, notwithstanding the material scale of the unregulated activity.
56. We also highlighted that even if an unregulated activity is anticipated to become widespread, a workably competitive market outcome would not involve returns from unregulated activities being immediately expropriated. Rather, businesses could reasonably expect to retain scope economies for

a period (potentially an extended period). In consequence, we submitted that suppliers of regulated and unregulated services should be able to retain the economies of scope from joint service provision for a period before passing them through to consumers.

57. The expanded cost allocation methodology does not address either of these important subtleties, and no explanation is offered by the Commission as to why it has chosen to overlook these matters. It is useful at this point to reiterate the statutory wording – particularly for bespoke activities, the requirement to comply with FDC methodology might deter investment. The proposal to not require FDC-based approaches for ‘marginally profitable’ activities is no answer, since businesses can retain *highly profitable* synergy benefits in competitive markets.<sup>35</sup> Given the importance of the workably competitive market benchmark, we are eager to hear the Commission’s thoughts on how its preferred option meets the requirement of the purpose statement and complies with s53T.
58. More generally, a key objective of the workshop should therefore be to allow the Commission the opportunity to explain the reasoning underpinning its preferred option. The basis upon which it has reached certain aspects of its emerging preferred view is presently unclear. Although certain facets of the option appear to be desirable (such as the preference for a principles-based approach), others are potentially problematic. In particular, we continue to be concerned that the preferred option may result too often in an unnecessary departure from ACAM.

#### **4. Rules and Processes Under a CPP**

59. Orion welcomes the Commission’s comments on possible approaches to an efficiency carry-over mechanism (**ECM**) in the DPP and in CPPs. However, we consider that this and other issues relating to rules and processes under a CPP are of secondary importance, and should not take up valuable time at the workshop. In particular, issues relating to detailed CPP design and structure which could be left until the March workshop on CPPs.
60. In our view, primacy should be given to discussions related to the establishment of the initial RAB and, to a lesser extent, the roll forward methodology and cost allocation. This is particularly true in circumstances where there is no fundamental disagreement about the principles

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<sup>35</sup> See: Orion New Zealand limited, *Post-Conference Cross Submission on Input Methodologies*, 15 October 2009, paras 48-53. It is unclear how the Commission’s proposal to assess the profitability of unregulated activities would work in any event. We are eager to hear at the workshop the Commission’s thoughts on how such an assessment might be undertaken.

applicable to ECMs, and the focus instead is on detailed design. We recommend that the Commission defers consideration of issues specific to CPP proposals and their application at the CPP workshop scheduled for 11 March. The 24-26 February workshop could then focus more narrowly on the regulatory processes and rules methodology required by s.52T(1)(c) and its relationship to the Commission's emerging views on the purpose statement .

61. In our view, this revised sequencing is more intuitive, and would enable discussions at the February workshop to focus on matters such as:

#### **Regulatory processes and rules**

- The specification and definition of prices;
- Identification of any costs that can be passed through to prices;
- Identifying circumstances in which re-openers could apply;
- The definition of, and mechanisms for dealing with 'price shocks'; and
- Any other items that the Commission intends to include within this input methodology.

#### **Setting initial RAB values**

- Assessment of possible methods to set the initial RAB; and
- Implementation issues.

#### **Roll forward of RAB**

- Assessment of possible methods to roll forward RAB; and
- Implementation issues.

#### **Cost allocation**

- The legislative basis for cost allocation; and
- The implications of the purpose statement for cost allocation principles.

62. Orion has made submissions in relation to each of the above matters, and welcomes the prospect of further discussions at the workshop. We note also that the Commission has sought in its EV Paper businesses' views on the potential application of an ECM. However, absent the Commission's

views on how it expects prices under a DPP or a CPP to be reset from one regulatory period to the next, it is very difficult to provide any meaningful feedback on how an ECM might operate under either price path. For these reasons Orion suggest pausing discussion of ECM issues until after the workshops, and until PwC has circulated its paper on the design of an ECM mechanism.

### **Concluding Remarks**

63. Orion can confirm that it will be attending the 24-26 February workshop, and our representatives will be Mr Rob Jamieson, General Manager Commercial for Orion, and Mr Greg Houston, a Director of NERA Economic Consulting.
64. 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](mailto:dennis.jones@oriongroup.co.nz).

Yours sincerely

A handwritten signature in black ink that reads "D. L. Jones". The signature is written in a cursive, slightly slanted style.

Dennis Jones  
**Industry Developments Manager**