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**SUBMISSION ON THE REGULATORY PROVISIONS OF THE COMMERCE ACT 1986:
DISCUSSION PAPER (19 DECEMBER 2008)**

- 1 Orion New Zealand Limited (**Orion**) welcomes this opportunity to make a submission in response to the above discussion paper.

Outline and summary points of this submission

- 2 The Commerce Commission's (**Commission**) discussion paper contains relatively little substance. Rather, the analysis of regulatory options is mostly abstract and academic. Although such an approach may be appropriate for industries that have not been subject to previous regulation, the same cannot be said for electricity distribution businesses (**EDBs**).
- 3 EDBs have been subject to the regulatory regime contained in Part 4A of the Commerce Act 1986 (**the Act**) since 2001, and are consequently well versed in 'first principles'. The time has come for close attention to the *detailed application* of those principles. For this reason, the Commission's apparent intended approach to consultation with EDBs causes some concern.
- 4 Further matters of concern are that:
 - 4.1 the scope of the discussion paper is particularly wide;

- 4.2 the time frame for submissions is unduly limited, given the scope of many matters raised for submission; and
- 4.3 in many cases, the Commission seeks submissions on matters upon which it expresses no views, but merely outlines wide ranging options. Until such time as the Commission articulates clear positions on all material matters, EDBs' ability to make meaningful submissions will be compromised, and the effectiveness of the consultation process undermined.

Summary points

- 5 Against this background, we respond selectively to the extent we can on some of the key matters facing EDBs. We provide a summary of our key points below:
 - 5.1 The Commission appears not to have appreciated the full import of the legislative change reflected in the new section 52A purpose statement. The additional express reference to innovation and investment incentives sends a clear signal that the Commission must focus more closely on these factors when making regulatory decisions. It is invalid for the Commission to contend that its previous approach to lines business regulation adequately accounted for such incentives. If that were the case then there would have been no need for Parliament to enact the new provision. The explicit recognition given to dynamic efficiency considerations in section 52A(a) sends a clear message to the Commission that it should be considering how its previous approach must be changed to accommodate the amendment.
 - 5.2 A consequence of the lack of recognition by the Commission of this shift in legislative priorities is continued uncertainty surrounding the balancing exercise implicit in the new purpose statement. Specifically, the way in which the Commission will seek to balance the paramount dynamic efficiency goals set out in section 52A(a) with the accompanying allocative and productive efficiency goals is unclear.
 - 5.3 The Commission holds out the FCM concept and NPV=0 principle as central guiding regulatory principles with multiple points of application, whereas in fact:
 - (a) FCM is a concept with strictly limited application, eg, it is not relevant to the initial valuation of the regulatory asset base

(RAB) and cannot legitimately be used to require backward-looking adjustments to be made to forward-looking prices;

- (b) Although the NPV=0 approach is an important financial concept, it has only limited application to the regulation of lines businesses and is of no assistance in price setting processes characterised by uncertainty over outputs and expenditures; and
- (c) Both concepts have significant *practical* limitations. For example, at paragraph 280 of the discussion paper the Commission states that it considers that the initial RAB for each business should be (as far as possible) consistent with NPV=0 over the life of the assets. However, measuring the return profile of distribution assets in this manner is impossible. The information required to do so is unavailable because historical cost estimates are unreliable.
- (d) In other words, these two concepts do not between them represent a panacea to all regulatory problems and they should not be represented as such. Indeed, for a good many regulatory decisions – such as setting the initial RAB – they are of no help whatsoever.

5.4 The C1 factor employed by the Commission under the thresholds regime to ostensibly account for the relative productivity of EDBs is a form of comparative benchmarking on efficiency. Consequently, following the introduction of section 53P(10) the C1 factor – or any similar analyses – can no longer be used in the determination of the default price/quality path (**DPP**), including the establishment of starting prices, rates of change, quality standards or incentives to improve efficiency.

5.5 It continues to be unclear what input methodologies (if any) the Commission considers to be of relevance to the reset of the DPP for EDBs, scheduled to occur on 1 April 2010. The discussion paper is silent on this issue. This matter requires timely and more focussed consideration because:

- (a) section 52P(3)(c) requires the Commission to specify which input methodologies apply to this reset; and
- (b) the Commission must strive to achieve consistency between these input methodologies (used in the context of this DPP

reset) and those which are ultimately enunciated in or after June 2010.

- 5.6 The discussion paper provides very little in the way of detailed proposals or options with respect to the critical input methodologies that will affect EDBs. Further, and more focussed, consultation is required on detailed proposals in relation to:
- (a) the asset valuation methodologies to apply to EDBs, including the methodology for setting initial asset values and accounting for changes in those values over time;
 - (b) the cost of capital; and
 - (c) the treatment of taxation and common cost allocation methodologies.
- 5.7 The appropriate base for tax depreciation should be the regulatory asset value, with the benchmark tax depreciation allowance derived by reference to that value.
- 5.8 There is no proper basis for the Commission's assertion that the new Part 4 regime imposes a requirement for expanded information disclosure requirements, over and above the requirements which applied under section 57T(1). On the contrary, there is compelling reason for reducing the current information disclosure because:
- (a) Orion, as a non-exempt EDB, is already subject to the rigours and potential liabilities of DPP regulation – this alone is a robust regulatory constraint;
 - (b) comparative benchmarking on efficiency is no longer permitted; and
 - (c) the publication of Asset Management Plans (**AMP**) sufficiently informs persons interested in assessing whether the purpose of Part 4 is being met.
- 5.9 The need for timely consultation and certainty in relation to the 1 April 2010 reset of the DPP for EDBs cannot be overstated. This matter must be completed by 1 December 2009, and that time is fast approaching. In particular, there needs to be timely signals from the Commission on the following matters:

- (a) Starting prices -- we acknowledge that the only workable approach in light of information and time constraints may be for the Commission to base starting prices on the prices that applied at the end of the preceding regulatory period.
- (b) Rates of change - we make a number of points including that:
 - i. while in principle Orion is comfortable with the rate of change being based in part upon the long-run average productivity improvement rate achieved by either or both of suppliers in New Zealand and other comparative countries, changes will need to be made to the way in which the Commission has previously set its 'B-factor' to meet the requirements of the new legislation;
 - ii the C1 factor will no longer be relevant; and
 - iii any adjustment to rates of change to reflect individual suppliers' profitability should be based on the current and projected profitability of each supplier.
- (c) Quality standards - Orion submits that a new approach is required in relation to quality standards. Further development of the Commission's 'S-factor' scheme may be a useful starting point.

Process issues

- 6 Notwithstanding the discussion paper's lack of specificity, we have endeavoured to respond to it to the extent possible at this time. We propose to elaborate further on the matters we have addressed, and all other matters which may be relevant to the EDBs, in the course of forthcoming consultation throughout 2009-10. However, we have significant concerns about the Commission's approach to consultation in respect of EDBs, including:
- 6.1 Extensive consultation since 2002 on key regulatory issues facing EDBs is not reflected in the discussion paper. Rather, on virtually every critical issue, the Commission simply invites wide ranging comments in the abstract.¹ It makes little attempt to articulate its own views or to adopt a preliminary position. Extensive consultation

¹ Discussion paper, paras 260-300.

over the last six years should be more than sufficient for the Commission to offer, at least, a preliminary view on issues such as its proposed approach to asset valuation and the cost of capital. In our view, the time for high-level discussion has passed – the Commission must provide its views on the detailed application of these matters to EDBs.

6.2 Turning to the Commission’s “Notice of Intention: Process for Determining Input Methodologies”,² we note that the Commission proposes to consult upon:

- (a) input methodology ‘guidelines’ (such as those for asset valuation and the cost of capital) in the second quarter of 2009, with a conference scheduled for the third quarter of 2009. Given the approach taken in the discussion paper, there is a material risk that the guidelines will entail a similarly misplaced emphasis on high-level abstraction rather than detailed proposals; and
- (b) draft input methodologies for each type of regulated service in the fourth quarter of 2009 and first quarter of 2010. No conference is proposed for this consultation round, although there is the prospect that workshops may be held with industry participants.

6.3 In other words, it is possible that EDBs will not be able to engage in targeted consultation on specific regulatory proposals until the fourth quarter of this year. This is unsatisfactory, in light of the fact that:

- (a) the Commission is required to undertake the 1 April 2010 reset of the **DPP** for EDBs by 1 December 2009; and
- (b) adequate time is needed to make and consider submissions on complex matters.

7 Against this background, we would welcome the opportunity to discuss with the Commission how the consultation timetable could be better tailored to the unique circumstances of EDBs, so that valuable consultation time is not wasted. A suggested alternative approach would be for the Commission to issue an industry specific consultation paper in the second quarter of this year, in conjunction with the proposed ‘Guidelines Discussion Paper’ on input methodologies. The paper would provide the Commission with an

² As elaborated upon in the discussion paper, paras 224-33.

opportunity to set out its draft views on the starting prices, rates of change and quality standards – all of which need to be finalised by 1 December 2009. There would then be the opportunity to address this matter at, or at the conclusion of, the proposed input methodology conference that is scheduled for the third quarter this year.

- 8 The remaining parts of this submission set out the reasons for the summary points we make above.

How should the new purpose statement, section 52A, be applied?

- 9 A significant change in the new regulatory landscape is the explicit legislative recognition in section 52A(a) that decisions made under Part 4 must now promote outcomes which provide regulated suppliers with incentives to innovate and to invest. This development is significant because, as the Commission notes in the discussion paper, dynamic efficiency is arguably the most important form of efficiency.³
- 10 We are concerned that the Commission has not appreciated the clear import of this legislative change. It asserts in the discussion paper that:
- 10.1 section 52A is similar to section 57E, which has been applied to EDBs under the current Part 4A of the Act;⁴ and
- 10.2 it has already appropriately taken into account dynamic efficiency considerations under Part 4A.⁵
- 11 More concerning still are the Commission's observations on the weighing exercise it perceives to be part of the new purpose statement. Specifically, it states that the various goals of allocative, productive and dynamic efficiency will need to be considered and that this task inevitably will involve trade-offs, and that:⁶

"[I]n weighing up such trade-offs in the context of the statutory purpose and objectives (i.e., in section 52A of the Act), the Commission will need to exercise its judgment in striking the appropriate balance between the interests of consumers and the interests of regulated suppliers."

³ Discussion paper, para 183.

⁴ Discussion paper, para 152.

⁵ Discussion paper, para 184.

⁶ Discussion paper, para 150.

- 12 The Commission does not articulate in the discussion paper:
- 12.1 the basis for its conclusion that it has previously given appropriate recognition to dynamic efficiency considerations when applying section 57E;⁷ and
 - 12.2 the means by which it will weight the various forms of efficiency under section 52A.
- 13 Despite the Commission's apparent contrary view, the treatment of innovation and investment costs remains an area of considerable uncertainty for EDBs. For this reason, it is troubling that the Commission considers that the approach it has taken to date under section 57E will satisfy the requirements imposed under section 52A. We do not agree with the Commission's assertion for the following reasons:
- 13.1 If Parliament had considered that a provision such as section 57E had adequately addressed dynamic efficiency considerations, there would have been no reason to enact the new provision. The addition of section 52A(a) sends a clear message to the Commission that *something more* is required to recognise innovation and investment incentives than was the case under section 57E – the status quo will not suffice.
 - 13.2 Despite the Commission's apparent opinion to the contrary, we do not believe it is apparent from adjudication, settlements and discussion papers precisely how innovation and investment considerations were treated under section 57E (and so would continue to be treated under section 52A(a)). The Commission has also not set out the basis for its belief that dynamic efficiency goals were achieved under Part 4A.
 - 13.3 Further, the Commission has not in the current discussion paper provided any views on its proposed approach to applying the dynamic efficiency goals set out in section 52A(a), or how it will seek to trade-off the various competing goals implicit in section 52A.
- 14 Against this background, the discussion paper does not provide an adequate basis for meaningful consultation on the application of section 52A at this time. However, we note that the Ministers for Commerce and

⁷ For the reasons outlined in paragraphs 21 to 25 of this submission, the Commission's analysis in paragraphs 192 and 194 of the discussion paper does not provide a basis for this conclusion.

Energy considered that “a key policy objective of introducing the provisions in [the Act] is to improve certainty and predictability for businesses, thereby promoting efficient infrastructure investment”.⁸ We trust that the Commission will in the course of forthcoming consultation meet these expectations, and we look forward to providing further submissions once it has articulated its view on those continuing areas of uncertainty and unpredictability outlined above.

What regulatory framework principles should apply?

- 15 Orion agrees with the Commission that the dynamic element of efficiency is of paramount importance in practice. As noted above, the explicit incorporation of investment and innovation goals in the new section 52A purpose statement is consistent with this emphasis. Investments in long-lived sunk assets are needed to provide electricity distribution services, and if suppliers are not appropriately rewarded for making efficient investments, then they will not choose to invest, to the detriment of both consumer and producer welfare.
- 16 If the regulatory regime exhibits clear regulatory principles, and those principles are administered openly, transparently and, most importantly, consistently, efficient investment – and thus dynamically efficient outcomes – can be fostered. As Orion has submitted on many occasions, a number of features of the regulatory arrangements applying to electricity distribution services have, in the past, inhibited the ability of businesses to invest with confidence that an appropriate return would be secured. These factors included:
 - 16.1 uncertainty surrounding the various components of the X-factor, most notably the C1 comparative productivity factor, which was incapable of accounting for differing levels of reliability thereby disadvantaging businesses with a particularly high proportion of under-ground wires, and provided businesses with few, if any, reasonable options to improve their rankings;
 - 16.2 uncertainty surrounding whether or not businesses had complied with the price ‘threshold’ until after the event, and the absence of any meaningful guidance from the Commission about what ‘control’ would entail, including the asset valuation principle that would apply and the WACC parameters that would be employed, i.e., the applicable ‘input methodologies’.

⁸ Discussion paper, para 196.

17 We therefore welcome the clear instruction in section 53P(10) of the Act directing the Commission to eschew from employing comparative benchmarking on efficiency when determining starting prices, rates of change, quality standards or incentives to improve quality of supply. When one considers the meaning of the term 'efficiency', it is immediately apparent that the C1 comparative productivity factor falls squarely within the exclusion and cannot survive the introduction of the Act.

18 Efficiency involves getting results with the smallest possible inputs, or getting the maximum possible output from given resources.⁹ The fundamental purpose of the C1 factor ostensibly was to benchmark the comparative performance of EDBs on this basis and to reward/punish them accordingly through an adjustment to their X-factor. The Commission sought to make precisely this point in its Thresholds Reset Methodology Update Paper:¹⁰

"While quantities are the primary drivers of the MTFP measure, the use of value shares to weight both the output and input quantities means that MTFP reflects both technical and allocative efficiency (where allocative efficiency refers to the mix of outputs and the mix of inputs). The input side of MTFP, in reflecting technical and allocative efficiency, seeks to measure EDB cost efficiency. When combined with a similar coverage on the output side, this produces a measure of overall economic efficiency." (our emphasis)

19 There is therefore no doubt that the C1 factor represents comparative benchmarking on efficiency and is no longer permitted. Indeed, the explicit legislative direction contained in section 53P(10) represents the clearest possible rejection by Parliament of the C1 factor or any similar analyses. Orion's dissatisfaction with the C1 factor has been well documented, so we derive significant comfort from contemplating a future regulatory regime where comparative productivity analysis will play no role.

20 We likewise welcome the prospect of settling upon a robust set of input methodologies following a comprehensive consultation process. Defining these critical parameters will deliver an element of much needed clarity for EDBs and engender greater confidence on whether to invest. Particularly critical factors are those relating to asset valuation. Although the Commission has undertaken a series of consultation processes in the past, at no stage during the evolution of the thresholds regime was an opening

⁹ *The Oxford Dictionary of Economics*, 2003, 2nd edn, Oxford University Press, New York.

¹⁰ Commerce Commission, *Regulation of Electricity Lines Businesses Targeted Control Regime, Threshold Reset 2009: Methodology Paper: Update*, 25 June 2008, p24.

asset valuation determined for the express purpose of determining regulated prices. We welcome the opportunity to engage with the Commission to resolve this issue once and for all.

Misplaced emphasis on FCM and NPV=0

- 21 Notwithstanding the positive developments outlined above, Orion remains concerned with the Commission's repeated references to the 'FCM concept' (or 'NPV=0' principle). Throughout its discussion paper, the Commission appears to regard FCM as a concept with extremely broad application to all manner of regulatory decisions. This is certainly consistent with the approach it employed in reaching its gas distribution services authorisation decisions for Vector and PowerCo, in which it sought to employ the FCM concept to:
- 21.1 assist in the determination of the opening **RAB**
 - 21.2 justify retrospective adjustments to opening asset values to adjust for alleged 'revaluation gains'; and
 - 21.3 set the framework by which forward-looking regulated prices would be established.
- 22 As Orion highlighted in a number of submissions throughout that process, the Commission has misconstrued the FCM principle. FCM is a *depreciation concept* that has strictly limited applicability. In particular, it is not relevant to the initial valuation of the RAB. Rather, the concept can be applied consistently to *any* initial opening RAB value.¹¹ In itself, it has no bearing on when or how that initial RAB is set. Moreover, the concept does not require backward-looking adjustments to be made to forward-looking prices to reflect short term fluctuations in asset values.
- 23 The Commission also understates the significant *practical* limitations of the two concepts. For example, at paragraph 280 of the Discussion Paper the Commission states that it considers that it should set an initial RAB for each business that is (as far as possible) consistent with NPV=0 over the life of the assets. Put simply, measuring the return profile of distribution assets in this manner is impossible. The information required to do so is unavailable because historical cost estimates of the relevant assets are unreliable.

¹¹ NERA and Mark Berry, *Review of Commerce Commission's Draft Gas Distribution Services Decisions Paper: A Report for Orion New Zealand Limited*, 30 November 2007, p19.

- 24 Attempting to employ the concept nonetheless by assessing the return profile over a shorter time period risks producing arbitrary results. For example, examining only the recent period of distribution assets' lives reveals very little about the overall return profile, which extends well before that brief historic period. There may have been numerous fluctuations in outturn returns over that longer time period. Indeed, recent periods of growth in asset values may be more than offset by an earlier period of low returns. There is no way of knowing this for certain without information on the efficient cost of the assets *at the time they were first installed*.
- 25 In sum, the FCM and NPV=0 concepts do not in combination represent a panacea for every regulatory issue and they should not be represented as such. Moreover, for some key regulatory decisions, such as determining opening regulatory asset values, these concepts are of no help whatsoever.

What is the role of input methodologies in the reset of the default price-quality path to apply to EDBs from 1 April 2010?

- 26 The Commission notes that there is no statutory requirement for input methodologies to apply to the 1 April 2010 reset of the DPP for EDBs.¹² It also notes that section 54K(2) enables the Commission to reset this DPP, even if all relevant input methodologies have not been set. This situation arises from the particular transitional arrangements for EDBs, whereby the DPP reset needs to be announced on 1 December 2009, which is some six months or so prior to the date that input methodologies must be finalised.¹³
- 27 Significantly, the Commission also acknowledges in its discussion paper that consistency of this DPP with relevant input methodologies may be important.¹⁴
- 28 However, the Commission does not indicate which input methodologies will be relevant to the 1 April 2010 reset of the DPP.¹⁵ This matter requires urgent attention because the section 52P determination, which will be required in this context by section 54K, must specify the input

¹² Discussion paper, para 219.

¹³ The Commission also notes the application of section 54K(3) in this context which provides that adjustments can be made if the input methodologies set after 1 April 2010 may have a material impact on the DPP set before this date.

¹⁴ Discussion paper, para 219. This position is required by section 52T(2)(c).

¹⁵ The topic is also in part canvassed in the discussion paper at paras 318-20, but this discussion advances no further the Commission's proposed position in relation to the relevance of input methodologies to the reset of the DPP to apply from 1 April 2010.

methodologies that apply.¹⁶ In particular, the Commission needs to consider the implications for the proposed consultation upon input methodologies.

- 29 There are obvious advantages for both the Commission and EDBs to engage in consultation upon those input methodologies of relevance to the 1 April 2010 DPP reset (whatever they may be) *well in advance* of 1 December 2009.
- 30 However, as noted earlier, the proposed timetable may not address issues in a substantive manner until the fourth quarter this year, by which time proper consultation will be impossible.
- 31 The obvious solution is for the Commission to articulate its views on the proposed approach to the 1 April 2010 DPP reset – including the input methodologies relevant to that reset – well in advance of the dates currently proposed. The significant work undertaken by the Commission on the 2009 reset of the Part 4A thresholds should leave it well placed to bring the timetable forward in this manner.

What asset valuation methodologies should apply to EDBs?

- 32 Since the inception of the thresholds regime, the Commission has favoured the optimised deprivation valuation (**ODV**) principle for valuing assets of EDBs. Orion has consistently supported the ODV methodology, since it represents the quantum that a hypothetical new entrant would be prepared to outlay to enter the market to compete with an incumbent, and thus is consistent with a contestable market outcome (workable competition). However, as noted above, at no stage during the life of the thresholds regime were asset valuations determined for businesses for the direct purpose of establishing regulated prices.
- 33 Consequently, the Commission's likely approach to asset valuation under the new control regime represents a significant area of uncertainty for EDBs. This uncertainty encompasses the valuation principle that will be adopted, the date at which that principle will be applied, and the way in which changes in asset values will be accounted for over time.
- 34 In Orion's view, there would be great benefit in addressing these questions once and for all. Specifically, we believe the industry would welcome the Commission setting in train a process and a suite of principles for establishing an opening asset value for all businesses, so that more

¹⁶ Section 52P(3)(c).

informed decisions can then be made about whether or not to submit customised proposals.

- 35 Unfortunately, the discussion paper does not do this. Rather, much of the material is presented at a very high level and does not take into account the particular challenges applicable to individual industries or information issues that may pragmatically effect the assessment.¹⁷
- 36 The Commission had indicated *previously* that it may consider ‘locking in’ an opening asset valuation – presumably based upon an ODV estimate – with roll-forward adjustments based on indexed historical costs thereafter. Orion welcomes the opportunity to make further submissions on these critical issues as the Commission releases more detailed proposals. However, the discussion paper does not provide an adequate basis for any further analysis of this particular issue at this time.

On what basis should the opening RAB be set and rolled forward for EDBs?

- 37 For the reasons outlined above, and in particular the absence of any specific proposal from the Commission to respond to, it is not possible to address this critical point at this time. However, we reiterate our earlier observations that the Commission should not conflate the two separate tasks that it must undertake by misconstruing the applicability of the FCM concept, namely:
- 37.1 *specifying an opening RAB*, which should be based on an ODV and should in no way be influenced by the FCM concept; and
- 37.2 *setting the framework by which forward-looking regulated prices will be established* – under which the opening RAB becomes the financial capital to be maintained, moving forward, assuming the FCM concept is adopted.
- 38 Orion looks forward to making further submissions to the Commission on these critical asset valuation issues as and when more detailed proposals are made available.

¹⁷ This highlights again the need for more focussed consultation that can narrow in more quickly upon the key issues and avoid lengthy consultation papers populated with textbook style exposition of economic theory.

What WACC should apply to EDBs?

- 39 The return on capital represents a critical component of an EDB's revenue stream. Consequently, it is surprising that the Commission devotes only two paragraphs of the discussion paper to the subject. Perhaps even more surprising is the absence of any reference to the extensive consultation that the Commission has already undertaken on this subject – particularly in relation to EDBs.¹⁸ The continued absence of guidance from the Commission on these critical issues is especially undesirable in light of uncertainty in the availability of finance as a result of current financial market turmoil, which is likely to result in increased competition throughout the economy for the limited funds available.
- 40 Until such time as the Commission is prepared to articulate its views on an appropriate WACC range for EDBs, there is no realistic basis upon which further consultation on WACC can proceed. Consequently, Orion once again looks forward to making further submissions when the Commission releases a more detailed proposal setting out its views.

What approach should be taken to tax and cost allocation?

- 41 As the Commission indicates¹⁹ it has generally applied a form of tax payable approach in performing its regulatory functions to date in the electricity, gas and airports sectors. Orion (and its advisers) has consistently opposed this approach.
- 42 We have previously submitted that the appropriate base for tax depreciation should be the regulatory asset value, with the benchmark tax depreciation allowance derived by reference to that value. Any other approach inappropriately results in EDBs being treated differently on the basis of whether they have held their regulated assets for a long period of time, or recently acquired those assets. In the latter situation a new owner also is treated differently depending on whether the assets were purchased directly or acquired through a share acquisition.

What information disclosure requirements should apply to EDBs?

- 43 Information disclosure regulation is the one form of regulation that applies to all EDBs. However, it will arguably be of greatest relevance to exempt EDBs, because it will be the *only form of regulation* which applies to them.

¹⁸ For example, there is no mention whatsoever of the expert WACC panel charged with reaching a view on these critical matters in relation to EDBs.

¹⁹ Discussion paper footnote 115.

- 44 Because non-exempt EDBs face the additional discipline of a binding price path (either the DPP or a customised path) there is reason to consider whether less exacting information disclosure requirements may be appropriate for those businesses. However, before allocating different requirements to exempt and non-exempt EDBs the Commission must be mindful of the following potentially conflicting aims:
- 44.1 on the one hand, the Commission is required to ensure that the purpose of section 53A is met, i.e., it must ensure that sufficient information is readily available to enable interested persons to assess whether the purpose of Part 4 is being met; and
 - 44.2 on the other hand, the Commission must avoid imposing undue compliance costs on EDBs – as it notes, this form of regulation is intended to be light-handed.²⁰
- 45 The discussion paper:
- 45.1 observes that section 53C sets out the type of information which may be required to be disclosed;
 - 45.2 expresses no view on which particular input methodologies may apply to information disclosure requirements;²¹
 - 45.3 in the case of EDBs, suggests that a wider information disclosure regime may be needed than currently applies under section 57T(1), because of the need “to meet the expanded regulatory objective”,²² and
 - 45.4 invites submissions on what changes should be made to the current information disclosure regulations as they apply to EDBs.²³
- 46 Orion considers that in demonstrating compliance with Part 4, the AMP published, in part, to comply with the Electricity Information Disclosure Requirements is the most important part of the information disclosure

²⁰ Discussion paper, para 361.

²¹ Discussion paper, paras 371-72.

²² Discussion paper, para 387. Presumably, the Commission is referring here to the new purpose statement under section 52A. However, this particular observation appears to contradict the Commission’s statements elsewhere in the discussion paper that the current information disclosure requirements already take into account all of the goals contained in section 52A, namely allocative, productive and dynamic efficiency – see discussion paper, paras 383-84.

²³ Discussion paper, paras 467-75.

regime. The AMP is fundamental to how we operate – it details how we plan to build, maintain and reinforce our electricity network over the next ten years (two regulatory periods). The foundation of our AMP is our consumers' views on the quality of service that they prefer.

47 We see no justification to expand information disclosure under the new regime. Rather, we consider that there is a case to reduce the current information disclosure requirements for reasons already mentioned above, namely that:

47.1 Orion is subject to DPP regulation (and potentially at a later date, a customised price path), and this alone acts as a sufficient constraint on our activities;

47.2 the explicit direction that the Commission may not use comparative benchmarking on efficiency in order to set starting prices, rates of change, quality standards, or incentives to improve quality of supply²⁴; and

47.3 the role that the AMP provides by itself in informing persons interested in assessing whether the purpose of Part 4 is being met.

48 In particular, we do not consider that there is any further need for the Commission to collect data to support comparative benchmarking on efficiency. This view appears to be shared by the Commerce Select Committee, which, while it recommended in its report on the Commerce Amendment Bill 2008 that the Commission's use of statutory powers to obtain information for the purpose of setting prices should be permitted, it did so on the basis that the previous restriction would no longer be required as a result of the clarification that the Commission should be precluded from undertaking comparative benchmarking on efficiency in determining the default price-quality path.²⁵

49 Orion has already engaged in useful discussions with the Commission and its advisers on information disclosure. Despite this dialogue, we remain concerned that an undue burden would remain if, for example, the form of information disclosure currently required under the 2008 information disclosure requirements remains – in particular the requirements to provide:

²⁴ Section 53P(10).

²⁵ Commentary to the Commerce Amendment Bill (201-2), Government Bill, as reported from the Commerce Select Committee, Wellington, 28 July 2008 p8.

- 49.1 data that we currently do not collect, such as valuation disclosures by prescribed asset class and price and quality splits on a connection point class/customer class basis;
 - 49.2 a breakdown of expenses as required in report FS1 and AM1 which are not based on our internal methodologies and therefore requires special processing to meet the Commission's requirements;
 - 49.3 the value of vested assets being included at ODV rather than at actual replacement cost which requires significant work to be done to recognise and track differences;
 - 49.4 the breakdown of capital expenditure into arbitrary categories in reports FS3 and AM1 which are not based on our internal methodologies and therefore requires significant work to reapportion internal data into the Commission's categories;
 - 49.5 a calculation of a regulatory tax allowance complete with notional interest and an interest tax shield adjustment which is subsequently added back in deriving regulatory return. We consider this requirement to be illogical and unnecessary; and
 - 49.6 the requirements of report AV3 and the roll-forward mechanism which is extremely complex and will require significant estimation within the categories required rather than in total.
- 50 These examples demonstrate the importance of the need for a close and ongoing dialogue between the Commission and EDBs, and we look forward to continuing discussions to determine the necessary content of information disclosure requirements and the potential burden these requirements impose on EDBs.

What approach should be followed for the reset of the DPP to apply to non-exempt EDBs from 1 April 2010?

- 51 The critical point in the transition from the old Part 4A threshold regime to the new Part 4 regime for EDBs will be the 1 April 2010 reset of the DPP. As already noted, this reset determination must be published by 1 December 2009.
- 52 This reset has three aspects – (1) the starting price, (2) the rates of change and (3) quality standards. We address each of these aspects below.

Starting prices

- 53 The threshold decision in approaching the DPP is clearly whether or not to adjust starting prices. However, the discussion paper contains very little analysis of this critical matter.
- 54 Given the history of EDB regulation under Part 4A of the Act, it is surprising that the Commission has made no attempt to express its views on appropriate starting prices for the 1 April 2010 reset.
- 55 The Commission simply notes that section 53P(3) provides that starting prices must be either the prices that applied at the end of the preceding regulatory period, or prices determined by the Commission for each supplier, based on the current and projected profitability of each such supplier.
- 56 The Commission then seeks views on the particular circumstances that might form a basis for the adjustment of starting prices for EDBs.²⁶
- 57 The principal difficulty with undertaking P_0 adjustments within the constraints of the new legislation is to find a way of ensuring that any profitability adjustment is forward-looking, without needing to undertake a full-scale building block analysis.²⁷
- 58 It is likely to be impracticable for the Commission to formulate, consult upon and apply a robust P_0 adjustment to every EDB in the time available given its already heavy workload.
- 59 On balance, the only workable approach would seem to be to use existing prices as the starting point for most businesses, while perhaps limiting adjustments to reining-in any clear outliers – say, based on an analysis of current profitability from the most recent disclosure accounts.

Rates of change

- 60 The scheme of section 53P enables individual rates of change to be set for individual EDBs. This approach applied under the Part 4A threshold regime. Presumably, there is the prospect that this approach will continue under the new Part 4 regime.

²⁶ Discussion paper, para 488.

²⁷ Application of the building blocks approach is limited to customised proposals.

- 61 The Commission again provides no views as to appropriate rates of change for EDBs in the discussion paper.²⁸ Rather, it simply poses some open-ended questions relating to appropriate productivity measures, indexation methodologies and potential data sources.
- 62 In *principle*, Orion is comfortable with the rate of change in prices being partially based upon the long-run average productivity improvement rate achieved by either or both of suppliers in New Zealand, and suppliers in other comparative countries.²⁹
- 63 However, we do not consider that the methodology used to date by the Commission to estimate industry-wide productivity using its 'B-factor' is fit for this purpose. It will need to be changed. The analysis is limited to a New Zealand dataset that is insufficient, in both quantity and quality, to produce a reliable estimate of long-run average industry-wide productivity. Indeed, if one considers the 'long-run' to be in the order of twenty-years the dataset is still in its infancy and is inadequate by definition.³⁰
- 64 Orion recommends that the Commission follow what other jurisdictions (like those in Canada) have done when faced with inadequate local data – employ estimates from other jurisdictions, such as the United States, where comprehensive electricity total factor productivity studies are available.
- 65 As Orion has submitted in the past, there are compelling reasons to give more credence to North American industry-wide productivity estimates, including the quality of the source data, the extension of the time series observations and the steady-state nature of North American productivity growth.³¹ We therefore urge the Commission to utilise this source of information.
- 66 Other important constraints in the new legislation will also have a bearing on the rate of change in prices. We have already noted that section 53P(10) prohibits the use of comparative benchmarking on efficiency when determining the rate of change. This precludes the continued use of the C1 comparative productivity factor.

²⁸ Discussion paper, paras 489-93.

²⁹ See section 53P(6).

³⁰ A total factor productivity (TFP) study must be based on a long term data set to ensure that estimates do not merely reflect short term fluctuations.

³¹ Makhholm, J., *Unacceptable Electricity Distribution Productivity Measures for Resetting the Price Path Threshold: Prepared for Orion New Zealand Limited*, 20 October 2003, p22.

67 In addition, we note that the express guiding principles in section 53P on the rate of change (apart from the prohibition under section 53P(10) just mentioned) are contained in sections 53P(6) to (9). These provisions outline certain rules to be applied in relation to rate changes, but they are not intended to be an exhaustive list of considerations. Against this background, we consider that certain principles applying to the starting prices, namely those principles introduced under section 53P(3)(b), should have equal application to the determination of rate changes. There is an obvious logic in applying consistent principles to both the establishment of starting prices and rate changes under section 53P. On this basis, sections 53P(3)(b) and (4) are of relevance to rates of change, such that any adjustment to rates of change to reflect individual suppliers' profitability³² should also be based on the *current and projected profitability* of each supplier. In other words, the Commission cannot through the operation of the default price path seek to recover any excessive profits made during any earlier period. The Commission is thus prohibited from employing retrospective adjustments to 'claw back' perceived excess returns.

Quality standards

68 Orion considers a new approach is required in relation to quality; as the previous quality threshold inevitably resulted in breaches beyond the control of the EDB. While this may have been acceptable under the threshold regime, we do not consider that this approach is acceptable under a regime where civil or criminal penalties can apply for non-compliance.

69 The Commission has previously indicated that:³³

"The purpose of the quality threshold is to provide incentives for lines businesses to not allow their reliability to fall as a means of reducing costs in response to the price path threshold, and to supply electricity distribution and transmission services at a quality that reflects consumer demands."

70 It would require a long term systematic approach to the reduction of quality for a non exempt EDB to reduce its quality to achieve a meaningful reduction in costs in response to a price path.

³² Such an adjustment might come about if the Commission calculated a P_0 adjustment based on profitability considerations, then sought to 'smooth' that adjustment by applying a different annual rate of change to that supplier, as contemplated in section 53P(8)(a).

³³ Regulation of Electricity Lines Businesses Targeted Control Regime Threshold Decisions (Regulatory Period Beginning 2004) 1 April 2004.

- 71 We consider that the AMP (which spans two regulatory periods) will provide the best indicator of any attempt by an EDB to subvert the intent of the price path in such a manner.
- 72 As indicated above, the foundation of our AMP is our consumers' views on the quality of service they prefer. Extensive consultation tells us that consumers want us to deliver electricity reliably and keep prices down. To meet this expectation we need to find the right balance between costs for consumers and network investment.
- 73 In addition to our AMP, Orion also publishes an annual network quality report³⁴ which provides additional information. Together, these documents cover the factors that Orion consider relevant in relation to quality.
- 74 We consider that the use of financial incentives along the lines of the 'S' factor scheme considered by the Commission during its 2009 threshold review may, with further work,³⁵ be useful to achieve improved quality standards.
- 75 Such a scheme could have rewarded Orion for its innovative initiative to introduce advanced new equipment from Sweden which has the potential to set new benchmarks for electricity delivery throughout Australasia.
- 76 Called a Ground Fault Neutraliser (**GFN**), the technology reduces the amount of electrical arcing at the point a fault occurs on the network. This reduces the level of threat to human life and risk of fire. It also allows electricity network operators to maintain power supply to homes and businesses, while staff are dispatched to fix the fault.
- 77 The GFN is expected to cost-effectively reduce interruptions to power supply by 20 to 40%. Transient or momentary faults can be neutralised as well, eliminating most cases of flickering lights and short term interruptions to power supply.
- 78 Any financial incentive scheme that the Commission chooses to implement should recognise the past investment in achieving quality and reliability already made by EDBs like Orion.

³⁴ <http://www.oriongroup.co.nz/downloads/NetworkQualityReport2008.pdf>.

³⁵ See Orion's comments on the S factor in our submission on the Threshold Reset 2009 Discussion paper. paras 62 to 68.

Concluding remarks

- 79 Thank you for the opportunity to make this submission. If you have any questions relating to this submission, please contact Dennis Jones (Industry Developments Manager) DDI 03 363 9526 email dennis.jones@oriongroup.co.nz.

Yours faithfully

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

Roger Sutton
Chief Executive Officer