

18 February 2008

David Healy
Chief Adviser
Network Performance Branch
Commerce Commission
PO Box 2351
Wellington

By email: electricity@comcom.govt.nz

SUBMISSION ON THRESHOLD RESET 2009 DISCUSSION PAPER

(A) BACKGROUND AND CONTEXT

- 1 Orion New Zealand Limited (Orion) welcomes the opportunity to respond to the Commerce Commission's Discussion Paper¹ in relation to resetting the price and quality thresholds for electricity distribution businesses (*EDBs*).
- 2 Orion's submission comprises:
 - 2.1 this letter, which forms the main part of our submission;
 - 2.2 an appendix that provides answers to the specific questions posed by the Commission; and
 - 2.3 a report drafted by NERA Economic Consulting, *Unacceptable Electricity Distribution Productivity Measures for Resetting the Price Path Threshold*, originally submitted for the 2004 threshold reset.
- 3 The Commission is obliged to set thresholds periodically under Part 4A of the Commerce Act 1986 (*the Act*). The existing thresholds began on 1 April 2004 and will expire on 31 March 2009.
- 4 In assessing thresholds, the Commission is required to consider the purpose statement that sets out the overall objectives of the threshold and control regime contained in Part 4A:²

¹ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Reset 2009, Discussion Paper*, 19 December 2007.

The purpose of this subpart is to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers –

- (a) *are limited in their ability to extract excessive profits; and*
- (b) *face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- (c) *share the benefits of efficiency gains with consumers, including through lower prices.*

5 The existing thresholds were developed in the context of a “targeted control” regime, where the thresholds were designed as screening mechanisms to identify businesses that may warrant control. A business that breached its threshold would only be placed under control following an investigation into the cause of the breach and an analysis of the costs and benefits of imposing control. Businesses that breached their thresholds also had the option of proposing an ‘administrative settlement’. To date, although there have been a large number of breaches, and several administrative settlements, no distribution business has been placed under control.

6 In parallel with the Commission’s threshold reset process, the Ministry of Economic Development (*MED*) and the Ministers of Energy and Commerce continue to develop wide-ranging proposed changes to Parts 4 and 4A of the Act. These proposed changes will significantly alter the regime under which EDBs are regulated. Most notably, the existing price thresholds will become a legally binding default price path, ie, a form of control.³ The recent Cabinet Paper that sets out the new regime summarises the proposed changes to the Commerce Act as follows:⁴

5) *‘...the following key amendments are proposed:*

a) *Specifying a purpose statement for Part 4*

² *Commerce Act 1986, Part 4A.*

³ Under the proposed new regime the Commission will have a range of powers where there is a breach of the default price path, including the power (a) to require compliance with the default price path and (b) to seek penalties and remedies. This is unlike the present threshold regime where a parallel enforceable controlled price does not emerge until such time as the Commission adjudicates upon an authorised price.

⁴ Cabinet Economic Development Committee, *Review of Parts 4 and 4A of the Commerce Act*, 22 November 2007, p.1.

b) *Provision for alternative forms of regulation in addition to conventional price control, namely:*

i) *information disclosure*

ii) *a negotiate/arbitrate regime (potentially suitable for sectors with a few large customers), and*

iii) *a 'default/customised price-quality path' regime for sectors like electricity lines to replace Part 4A. This would allow the Commission to set a default price-quality path (like Part 4A) while providing an ex-ante, time-bound opportunity for a firm to seek a customised path (eg where it needs to make a step-change in investment to maintain quality standards required by consumers)*

c) *A more conventional, qualitative test (with quantification where possible) for when regulation may be imposed. Decision-making powers on whether to regulate would remain with the Minister of Commerce, in consultation with sector ministers*

d) *A requirement that "input methodologies" (how to determine the cost of capital, value assets, allocate common costs etc) should be set as soon as possible by the Commission with the aim of improving certainty and predictability for businesses. Commission decisions on input methodologies would be subject to merits appeal to the High Court.*

6) *It is also proposed that trust-owned electricity lines businesses (17 out of 28 ELBs) be subject only to information disclosure, while the 'default/customised price-quality path' approach would be applied to other ELBs and to gas pipelines.'*

7 The 'default/customised price-quality path' is to apply from 1 April 2009, and the working presumption is that the thresholds established by the Commission and due to come into effect on that date will become the first incarnation of the default price-quality path. In other words, the exercise currently being undertaken by the Commission is, in effect, likely to result in the setting of a legally binding controlled price path, and this is recognised by the Commission.⁵ Following the breach of a default or

⁵ See eg Discussion Paper, page ii and para 7.

customised price path, the Commission will have recourse to conventional penalties or remedies that apply under section 70C of the Act.

- 8 Against this background, there is a legitimate expectation that the Commission must have regard to the proposed transition to the new default price-quality path in the context of the 2009 threshold reset. This transition of the 2009 threshold to the new regime is therefore a relevant consideration, and this has important implications for both the consultation process and the form of the thresholds. We expect a draft of the new legislation to be released within the next month or two. Once the nature of the draft legislation is known, the Commission must take it into account in developing the thresholds.⁶
- 9 Although the Commission claims to have considered the impacts of this transition process, we do not consider that it has fully appreciated them.
- 10 We also note that the Commission's timeline implies the final thresholds will be gazetted on 1 April 2009. It is standard for EDBs to provide between 40 and 90 days notice to retailers and customers, in addition to a possible consultation period, before price changes are implemented. To provide sufficient time for EDBs to undertake consultation and provide sufficient notice, Orion submits that the thresholds must be finalised and gazetted by the end of November 2008.

⁶ We note that amendments to the Commerce Act are due to be introduced into the House in mid-March. See Lianne Dalziel's speech *Examining New Zealand's Competitive Environment - Business as Usual or Room for Improvement?*, 18 February 2008.

(B) THE DISTINGUISHING FEATURES OF A CONTROL REGIME

Control versus threshold regimes

11 As just noted, the Commission's Discussion Paper must take into account the prospect that the 2009 reset will result in establishing a default price path that will operate under a legally binding control regime under a revised Part 4/4A of the Act. The contrast to the existing thresholds regime is stark:

11.1 under the threshold regime, a breach triggers an investigation into:

- (a) the reasons for the breach;
- (b) an analysis of whether the benefits of control would outweigh the costs; and
- (c) provides an opportunity for an administrative settlement; and

11.2 in contrast, a breach within the context of control involves an EDB breaking the law, and it is proposed that the attendant consequences under the Act in this setting include conferring on the Commission a right to seek penalties and remedies for breach of the default price path (in addition to powers requiring compliance with the default price path).

12 Accordingly, businesses are legally obliged to comply with the specified price path under a control regime. The greater seriousness attached to a breach also implies greater accountability on the part of the Commission for its decisions in setting such a price path. Setting price controls necessarily involves a more demanding process than setting a price threshold.

13 The Commission acknowledged the important distinction between a threshold and a control regime in a 2003 discussion paper when it was establishing the existing thresholds. A key criterion used by the Commission in determining an appropriate methodology for the current thresholds was that the approach be:⁷

'... consistent with the intent of a threshold, *as opposed to a form of control*. [Emphasis added.]

⁷ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Decisions (Regulatory Period Beginning 2004)*, 1 April 2004, p29 Table 2.

- 14 In discussing the application of this criterion to the methodology for developing thresholds, the Commission made the following comments in 2003:⁸

"The criteria the Commission proposes to use to determine the methodology for resetting the price path threshold are described in the table below. Apart from criteria directly derived from the statutory objectives of Part 4A of the Commerce Act, a key criterion is that *the methodology serves as a screening mechanism* to identify lines businesses whose performance may warrant further investigation and, if required, control by the Commission. *The methodology is not intended to transform the price path threshold into a form of control.*"
[Emphasis added.]

- 15 Consistent with this principle, the Commission has repeatedly emphasised that the thresholds are *screening mechanisms*, not a form of control, and so require a different regulatory approach. We agree with this distinction: the development and operation of a control regime is a fundamentally different proposition to simply continuing the existing thresholds scheme past 2009.
- 16 Notwithstanding the central importance of this distinguishing feature, in its most recent Discussion Paper the Commission has removed all references to it without any explicit recognition or justification. Not only has the previous "key" criterion differentiating between thresholds and control been excised, but the Commission no longer refers to the thresholds as a "screening mechanism". These are substantial developments worthy of explanation.
- 17 Orion appreciates that, if the revised legislation is passed, it is planned that the thresholds convert into a form of control, and that this may give rise to discomfort in terms of the way the role and function of thresholds have been thought about in the past. However, simply eliminating the previous "in principle" distinction between thresholds and control and so failing to address its practical implications is not an adequate basis for consultation. Indeed, notwithstanding the profound nature of the contemplated regime change, the Commission's proposed approach to establishing the thresholds is substantially unchanged. Not only does this contradict its earlier position, but it also appears not to recognise that a control regime is a fundamentally different proposition from simply maintaining the existing thresholds regime.

⁸ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Resetting the Price Path Threshold, Discussion Paper*, 30 May 2003, p6 para 5.

- 18 If the thresholds are reasonably going to be converted into the default price path under a new control regime, more careful consideration is required than is presently reflected in the Commission's Discussion Paper. We elaborate on these issues in the following sections.

Importance of clarity and detail

- 19 An essential aspect of any regulatory regime is that the businesses being regulated must be directly involved in the process of developing that regime. This is true under a relatively light handed regime, and is even more so in regimes characterised by 'heavier-handed' forms of control. For EDBs to participate meaningfully in consultation on the Commission's proposals, they must be presented with sufficient degree of clarity and specificity. Unfortunately the proposals contained in the Discussion Paper do not exhibit these characteristics.
- 20 Rather, the Commission's Discussion Paper is insufficiently developed to allow for a meaningful discussion of approaches to resetting price thresholds which are likely to be adopted as controlled prices. In a number of instances it is very difficult to evaluate the proposals comprehensively since many critical aspects of their detailed operation are not analysed or discussed in any acceptable level of detail. Furthermore, the Commission does not always justify its views, and does not take an initial view on many issues of relevance.
- 21 The Discussion Paper lacks precision in its discussion of the methodological options it identifies. By way of example:
- 21.1 the Commission does not address any of the fundamental challenges that arise in establishing thresholds suitable for conversion into a binding price path, most notably establishing an appropriate opening asset base and ensuring the methodology underpinning the price path is robust. Despite stating it would take the revisions to Part 4A into account, the Commission barely mentions the changes throughout the paper, and neglects to provide any analysis of its proposals within the context of a control regime;
- 21.2 the Commission notes that alternatives to benchmarking include full building blocks and partial building block approaches. These methodologies are "described" in a perfunctory fashion, with very little analysis of the appropriateness of their application for the threshold reset, and then not mentioned again throughout the Paper. Even if these approaches are not the preferred option, the minimal

analysis of these alternatives makes it difficult to comment which methodology is most appropriate;

- 21.3 the Commission does not provide any new discussion on the potential application of a partial building blocks approach, but simply reproduces similar materials to those provided in 2003 without any discussion of whether its views remain unchanged, or any reference to the appropriateness of a partial building blocks approach in the context of control. The Commission does not even pose the question of whether benchmarking should continue to be the preferred approach;
- 21.4 the Commission raises the option of an X-factor glide-path set for each EDB to ensure its notional revenue requirement equals costs in the final year of the period, based on a proposal advanced by Hawke's Bay Network during the 2003 investigation into setting thresholds.⁹ Despite apparently including it as a possibility, the Commission does not provide any details on how this option would work – for example, it is not clear whether “meeting costs at the end of the regulatory period” applies to costs as they are now, or as they are expected to be in five years' time; and
- 21.5 the Commission does not articulate clearly how it would derive any P_0 adjustment. It notes that P_0 adjustments may be appropriate to account for relative productivity, relative profitability, depreciation in excess of that required for renewal investment, and as an investment incentive. However, without knowing, for example, whether any such adjustment is likely to be made so that the net present value of the revenue stream is less than or equal to the alternative glide path it is difficult to evaluate whether they are appropriate.
- 22 We recognise that the Discussion Paper is preliminary in nature. However, unless sufficient details of the relevant options are clearly specified EDBs are unable to participate meaningfully in this consultation. In our view, there is a strong case to be made for clarifying these issues up front, rather than leaving critical issues unresolved and running into unintended outcomes when the thresholds are implemented and, more importantly, converted into a default price path.

⁹ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Reset 2009, Discussion Paper*, 19 December 2007, p.34.

A robust methodology is essential

- 23 Given the likelihood that the 2009 thresholds will become the default price path under the revised Part 4 legislation, it is essential that the methodology used to determine the revised thresholds is sufficiently robust to facilitate a smooth transition. As discussed above, the consequences for an EDB breaching the default price path will differ materially to the existing threshold regime. It is therefore important that businesses have confidence that the methodology implemented will provide an equitable and efficient outcome.¹⁰
- 24 In examining potential approaches to resetting the price thresholds the Commission does not appear seriously to consider approaches other than benchmarking, despite seeking to ensure a partial building blocks approach will remain a legitimate regulatory tool following changes to Part 4A.¹¹ The Commission recognised in 2003 that benchmarking has its shortcomings, but concluded that ensuring the methodology for developing thresholds under a threshold and control regime was robust, was not absolutely essential. The Commission stated:¹²

A number of issues would need to be resolved to implement robust benchmarking. The major difficulty with benchmarking is that apparent differences between businesses could be caused by failing to take account of important cost drivers or from the choice of variables used to measure output. Thus, the analysis may wrongly identify businesses as inefficient because of omitted variables, or because an unsuitable measure of output is used. However, the Commission notes that, at the investigation stage of the targeted control regime, lines businesses will have the opportunity to explain such issues.

¹⁰ We recognise that businesses eventually will be able to adopt a customised price path that will take account of their specific situation, however it is not clear when that might occur. The Commission has indicated it will take three years to develop input guidelines, and the MED has suggested the Commission will only have to review four proposals for customised price paths each year. Therefore it could be some time before customised price paths are in place.

¹¹ The Commission argued in its submission to the MED "When sharing efficiency gains, for example, the Commission may look to use a partial building blocks approach to provide the appropriate levels of information in order to establish mechanisms to share efficiency gains, including by using P_0 adjustments where appropriate". See Commerce Commission, Letter to Geoff Conner, *Comments on Design Details: Commerce Act Review of Parts 4, 4A, 5, 6* December 2007, p.5.

¹² Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Resetting the Price Path Threshold, Discussion Paper*, 30 May 2003, p10 para 14.

25 Similarly:¹³

...it is likely to be less important to ensure that the parameters derived are precise and correct in a thresholds regime. Distribution businesses that were wrongly caught by the threshold would have an opportunity to explain their position to the Commission during an investigation.

26 Whilst this reasoning may arguably be appropriate in the context of a thresholds regime, it no longer holds in the context of a *control* regime where price paths are legally binding. EDBs will no longer have the opportunity to explain a breach during what is at present only an investigation phase. Rather, as already noted, it is proposed that breach of the default price path may of itself provide grounds for the Commission to seek penalties and remedies, and to insist on ongoing compliance with the default price path. Therefore, it is critical that the price paths are set at an appropriate level *in the first instance*.

27 The Commission has not addressed the very issues it has previously identified as being problematic for undertaking benchmarking analysis, including:¹⁴

27.1 the choice of benchmarking approach is somewhat subjective and can result in different rankings;¹⁵

27.2 omitted variables may prevent the accurate estimation of relative efficiency between businesses;

27.3 the choice of output measure in econometric modelling may significantly impact efficiency rankings;

27.4 the choice of analytical technique used for benchmarking may impact efficiency rankings; and

27.5 there is no strong theoretical basis for converting assumed differences in efficiency into C-factors.

¹³ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Resetting the Price Path Threshold, Discussion Paper*, 30 May 2003, p107 para 7.12.

¹⁴ See Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Resetting the Price Path Threshold, Discussion Paper*, 30 May 2003, pp. 10 and 82-83.

¹⁵ This arguably is evidenced by the dramatic shifts in the relative rankings of EDBs' C₁-factors following the Meyrick's updated methodology. This is discussed further below.

- 28 The problems identified above are generic to the benchmarking approach. In addition, the approach adopted to determine the precise specifications of the thresholds which involves productivity and profitability analysis, is itself not robust. In particular, there are profound methodological issues associated with the total factor productivity (*TFP*) approach to benchmarking adopted by Meyrick which we examine in more detail in the following section.
- 29 In summary, there is strong reason to believe that the benchmarking approach that has been applied by the Commission to date will no longer be appropriate following the transition to control. In the following section we consider an alternative approach that may prove more appropriate under a revised Part 4.

(C) A REVISED APPROACH IS REQUIRED

- 30 Orion believes that a partial building blocks approach is a necessary minimum for control, together with an appropriate P_0 adjustment to ensure all EDBs enter the new regime on an equal basis, and the application of a CPI-X price path, where X is common to all businesses.¹⁶ The approach would use historical data to set revenues, but would not make any firm-specific cost forecasts. This approach is consistent with the overall approach suggested in Orion's submission on the previous threshold reset.¹⁷
- 31 To the extent that the existing disclosure data and input methodologies are insufficient to allow the Commission to undertake a robust application of a partial building blocks approach, Orion supports refinements to the information disclosure regime and the development of input methodologies that would enable the implementation of a partial building blocks approach. If this prevents the Commission from undertaking robust P_0 adjustments prior to April 2009, then Orion submits that the price thresholds should not be converted to the default price path until such time as this adjustment is possible.
- 32 We note that the Commission stated in its submission to the MED on the proposed changes to Part 4A:¹⁸

Currently the Commission is embarked on the reset of the thresholds for April 2009. In doing so there are areas in which P_0 adjustments based on partial building blocks may be appropriate.

¹⁶ An alternative approach to benchmarking is the standard building blocks approach that is commonly used in control regimes. In its Discussion Paper the Commission rejects a full building blocks methodology for developing thresholds on the basis that New Zealand is too small and that such an approach would not be cost effective, although we note that this is precisely the approach that it is taking in determining prices under a control regime in the gas distribution industry. Notwithstanding, undertaking a full building blocks approach would be inconsistent with the MED's proposed changes to Part 4A, which state "*The Commission may not undertake a building blocks or detailed forward-looking investigation of firms in setting default paths*".

The Commission appears to also reject a partial building blocks approach, expressing a preference for benchmarking, without any clear justification. The Commission states that it will consider partial building blocks, but does not mention the approach again. Instead it focuses its discussion on a benchmarking technique that is not robust and is inconsistent with the application of price controls.

¹⁷ Orion, *Cross Submission: Regulation of Electricity Lines Businesses: Targeted Control Regime*, Draft Decisions, 21 March 2003. We note that although the overall approach is the same, there may be some differences in the specific application of the methodology as the previous submission was in the context of a threshold regime only.

¹⁸ Commerce Commission, Letter to Geoff Conner, *Comments on Design Details: Commerce Act Review of Parts 4, 4A, 5, 6* December 2007, p.5.

- 33 However, as raised above, the Commission makes no comment on how it intends to derive the P_0 adjustment within the contexts of its Discussion Paper. Consequently it is not clear whether the Commission intends that any adjustment would be undertaken using a partial building blocks approach, a benchmarking approach, or some other approach.
- 34 A critical distinction between the partial building blocks approach and the benchmarking approach is the need under a partial building blocks approach to establish an appropriate opening RAB for each business. The asset base makes up a large proportion of EDBs' costs, and is therefore ordinarily an essential input into the determination of prices. Indeed, no credible regulatory control regime of which we are aware sets regulatory prices without addressing the basis for how investment in the assets that underpin service delivery will be remunerated. The specification of the opening asset values for the purposes of establishing initial prices and the determination of the way in which changes to asset values over time will be treated by the control framework are critical considerations, yet the Commission has not addressed this important issue in its Discussion Paper.
- 35 The determination of regulatory asset values for pricing purposes has not played a significant role in the thresholds regime to date. Although an ODV valuation has been used for some aspects of the information disclosure regime, its only application within the thresholds regime has been as an input into Meyrick's productivity and profitability analysis. The Commission has also considered the value of the asset base during its investigations into control for those EDBs that have breached their thresholds, but no value or opening date was ever determined.¹⁹
- 36 At no stage has a RAB value been derived by the Commission to form a key input into regulated prices. In Orion's view, if the reset thresholds are to be converted into the default price path under the new control regime, then it is crucial that an appropriate opening RAB is established.
- 37 A related issue that requires consideration is the way in which *changes* in the value of the RAB will be measured, and how revaluation gains or losses arising from such changes will be treated. Orion has consistently acknowledged that revaluation gains are an uncontroversial aspect of economic income. However, as outlined in its submission on the

¹⁹ We note that the Commission stated it would use the 2004 ODV revaluation as a *starting point* for control investigations, however this value was subject to change. See Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Assessment and Inquiry Guidelines*, 19 October 2004.

Commission's Draft Authorisation Decisions in relation to the gas distribution network services of Powerco and Vector, the consideration of revaluation gains should not extend to an examination of events prior to the inception of regulation, and more particularly, the opening RAB. Consistent with this principle, the Commission noted in its draft decision on the existing thresholds:²⁰

The main distinguishing feature of a partial building blocks approach is that the proposed adjustment to the price path would be based on an explicit consideration of profits at the beginning of the regulatory period. The resulting price path would not "claw back" excessive profits (if any) earned prior to the regulatory period, but would limit them in the future by explicitly realigning prices to actual costs.

38 The Commission also stated:²¹

Making P_0 adjustments in the future on the basis of an individual business' future costs and profits involves risks to efficiency. Periodic P_0 adjustments result in a regime which has some of the characteristics of (lagged) rate of return regulation. These adverse incentives can be ameliorated, but not removed by use of a glide path.

39 These issues will require serious consideration before control is implemented. In this regard, we also note that the Minister has acknowledged that:²²

"The government believes that the focus of economic regulation should be cooperative, forward-looking and incentive-based, where the regulator and businesses work collaboratively to seek to mimic the outcome of competitive markets."

²⁰ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Draft Decisions, Resetting the Price Path Threshold*, 5 September 2003, p.29-30.

²¹ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Resetting the Price Path Threshold, Discussion Paper*, 30 May 2003, p.95, para 5.35.

²² See Lianne Dalziel's speech *Examining New Zealand's Competitive Environment - Business as Usual or Room for Improvement?*, 18 February 2008.

(D) COMMENTS ON DISCUSSION PAPER

- 40 Orion believes that the Commission should seek to adopt a partial building blocks approach when resetting the price threshold for EDBs. Should the Commission decide to persevere with the existing TFP-based methodology, Orion would have serious concerns about the robustness of the resulting thresholds. Orion is also concerned about several other aspects of the Commission's Discussion Paper, including:
- 40.1 its interpretation of depreciation and its proposal to undertake a P_0 adjustment to remove so-called "excess depreciation";
 - 40.2 its discussion of incentives does not recognise that efficiency is in large part brought about by certainty about the way in which prices will be set in the future; and
 - 40.3 its suggestions about the revised quality threshold are insufficiently developed.

Meyrick's analysis is not robust

- 41 Meyrick has been re-engaged by the Commission to update the productivity and profitability analysis undertaken in 2003 to determine the factors in the price threshold. Meyrick has updated its initial analysis for the years 1999 to 2003 to take account of new information in addition to including new data for the years 2004 to 2006. These changes include:²³
- 41.1 adjustments that have been made to The Power Company and Top Energy's reported line lengths;
 - 41.2 deemed revenue is now net of discounts²⁴; and
 - 41.3 half of EDBs incorrectly reported their interest tax shield as being negative when, by definition, it must be positive. Meyrick therefore took the absolute value of the interest tax shield for the purpose of its analysis.
- 42 Aside from these adjustments, Meyrick's analysis appears substantially unchanged. It follows that many of the criticisms made by Orion in regard

²³ Meyrick and Associates, *Electricity Distribution Business Productivity and Profitability Update*, 7 December 2007, p.8.

²⁴ Previously a pre-discount equivalent line charge measure was used.

to the initial analysis continue to apply. These concerns are briefly outlined in the following sections. For a full critique please refer to the report by NERA Economic Consulting, prepared for Orion, *Unacceptable Electricity Distribution Productivity Measures for Resetting the Price Path Threshold*, which has been resubmitted for this consultation.²⁵

Industry wide productivity

- 43 Meyrick's application of total factor productivity (*TFP*) analysis to derive industry wide productivity (B-factor) is not robust for several reasons:
- 43.1 data quality remains poor. The data obtained from the information disclosure reports is not adequate for TFP analysis. Consequently Meyrick is unable to construct key variables that would usually be included in the analysis, such as labour quantity. Furthermore, the information disclosure data continues to be prone to inadequate reporting, and data inconsistencies remain problematic;
 - 43.2 the productivity factors have been derived from data that covers a relatively short time frame, and as such are highly volatile. This is illustrated by the substantial change in measured industry-wide productivity from the addition of just four more years data,²⁶ from trend growth of around two per cent per annum to just 0.9 per cent; and
 - 43.3 the results are not benchmarked against reliable international EDB productivity analyses, which suggest industry wide productivity in the region of 0.9 per cent in the long run.²⁷
- 44 For these reasons Orion believes that Meyrick's methodology for deriving the B-factor is insufficiently robust, either for use as a threshold or for developing price controls. Orion remains of the view that until New Zealand has a data set of sufficient quality that covers a sufficiently long time frame to ensure the results are not subject to significant and unexplained fluctuations, the Commission should instead rely on more robust international analyses.

²⁵ Originally appended to Orion, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Draft Decisions – Resetting the Price Path Threshold, Submission by Orion*, 20 October 2003.

²⁶ The 2003 analysis did not include 2003 due to the need to account for the purchase of United Networks by Vector, Unison and Powerco.

²⁷ See NERA Economic Consulting, *Unacceptable Electricity Distribution Productivity Measures for Resetting the Price Path Threshold*, October 2003.

Comparative productivity

- 45 The updated Meyrick multilateral total factor productivity analysis (*MTFP*) used to derive the C_1 factor exhibits similar problems, and has proven highly susceptible to definitional issues.
- 46 Under the updated analysis, Orion has dropped from 11th to 23rd in the relative productivity ratings, following a change in the way capital input shares are derived. Electricity Invercargill and Nelson Electricity have dropped from the top two to close to the bottom of the rankings for the same reason. This drastic reversal in rankings provides an indication of how susceptible the MTFP methodology is to arbitrary definitions and assumptions, and its consequent unsuitability for establishing price paths.
- 47 The underlying cause of the fall in ranking for these businesses appears to be the large proportion of undergrounding that Orion, Electricity Invercargill and Nelson Electricity, among others, have undertaken. The inability of the analysis to account for the associated increases in the level of reliability and service quality offered by this undergrounding, albeit at a higher cost, represents a fundamental flaw in the C_1 factor approach. Furthermore, undergrounding is mandated by local councils, and so is outside the control of managers to a great extent. Meyrick notes in its 2003 analysis that it is “*desirable to ‘normalise’ for at least the most important operating environment differences*”.²⁸ The mandating of expensive undergrounding is an uncontrollable environmental factor which should be accounted for in developing rankings.
- 48 Moreover, as we outlined in 2003, there is simply no precedent for the use of C-factors to adjust for differences in productivity between businesses. In fact, when not operating in a full building blocks framework, it is very rare for regulated businesses to be subject to different X-factors under price control:²⁹

A central tenet of price cap regulation is that the X-factor represents the competitive hurdles facing industry as a whole – not an individual firm. If the X-factor is determined on the basis of individual company performance, the price control mechanism will be compromised. The company will not experience a general incentive to maximize its efficiency; rather than trying to improve its earnings potential by

²⁸ Meyrick and Associates, *Regulation of Electricity Lines Businesses, Resetting the Price Path Threshold – Comparative Option*, 3 September 2003, p.39.

²⁹ NERA Economic Consulting, *Unacceptable Electricity Distribution Productivity Measures for Resetting the Price Path Threshold*, October 2003, p.28.

increasing its productivity, it will have every motivation to try to game the control mechanism. For this reason, an exogenous standard such as the industry trend is highly preferable to a company-specific X-factor.

- 49 There may be cases where it is appropriate to account for material differences in the markets in which EDBs operate, however any differences must be justified. Neither Meyrick nor the Commission have provided such justification.
- 50 Finally, analysis undertaken by NERA using a robust data set shows that there is no relationship between a company's existing productivity and its future productivity. This undermines Meyrick's assumption that EDBs with comparatively high initial efficiency levels are expected to achieve lower productivity growth going forward than those with initially low levels of efficiency, and thereby undermine the applicability of the C_1 factor.

Comparative profitability

- 51 The use of benchmarking for the C_2 factor is a poor substitute for a partial building blocks analysis. The C_2 factor is an imprecise measure of excess profits, which cannot capture actual levels of profitability with sufficient accuracy to be a valid tool for determining a price path.
- 52 As discussed in Orion's submission on the draft decision for the 2004 reset, Meyrick's calculation of the C_2 factor is fundamentally flawed. Although some of the issues we raised in 2003 were resolved in the final analysis, the following remain outstanding:
- 52.1 the Meyrick report uses a global estimate of depreciation, based on 4.5% of ODV. This is a highly simplistic approximation that results in considerable differences between Meyrick's depreciation assumption and the figures gazetted for each lines company under disclosure regulations; and
- 52.2 there is a range of problems associated with the derivation of ODV prior to the revaluation in 2004. These include out of date unit costs and asset lives being systematically understated.

Depreciation

- 53 The Commission has calculated a "depreciation proxy" based on 4.5% of ODV, and compared this result to the estimated replacement investment requirement for each EDB for the next regulatory period. Where the

“depreciation allowance” significantly exceeds the “replacement investment requirements”, the Commission proposes to undertake a P_0 adjustment to remove the excess allowance.

- 54 The Commission’s analysis is insufficient to support the P_0 adjustment it contemplates. Simply put, it presupposes a connection between EDBs’ asset values (and hence their depreciation profiles) and prices that does not exist. Orion agrees that if prices are set by reference to an opening RAB and updated by reference to changes in that value, normal returns can be expected over the lives of the relevant assets. However, although the Commission’s claims that “*the current thresholds were set on the basis of a relatively smooth asset age profile*”,³⁰ prices were *not* set by reference to an agreed or explicit regulatory asset value. The Commission based its current price path threshold on benchmarking using comparative productivity and profitability analysis. That benchmarking involved, at best, a tangential dependence of ODV values in combination with assumptions as to depreciation allowances. This process was sufficiently high level and aggregated for there to be no meaningful connection between ODV, which the Commission uses to determine its depreciation proxy, and prices.
- 55 In other words, observed disparity between the depreciation proxy and replacement expenditures is entirely a function of the Commission’s own benchmarking approach to specifying the price thresholds, and all of the approximations and assumptions that this involved. It is therefore not valid now to use this analysis to impose price adjustments because some of those benchmarks appear to be out of line.
- 56 In any case, the Commission’s contention that its depreciation proxy (however good a predictor of economic depreciation) represents the annual requirements for replacement expenditure is itself not a valid relationship in a context where network replacement expenditure can vary substantially from one year to the next for quite valid reasons.
- 57 This is further illustration of the advantages of employing a partial building blocks approach rather than a benchmarking approach.

Investment incentives

- 58 The Commission has proposed two alternatives for incentivising efficient renewal investment, namely:

³⁰ Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Reset 2009, Discussion Paper*, 19 December 2007, p.52, para 237.

- 58.1 an I-factor adjustment that would be EDB-specific and only applied in circumstances where an EDB could prove a significant increase in capital expenditure was required; and
- 58.2 an annuitised cost of capital approach, which would allow for a normal rate of return to be earned over the life of the asset.
- 59 The Commission expressed a preference for the I-factor approach, but noted that analysis undertaken by Farrier Swier Consulting (*FSC*) suggests that there is unlikely to be a significant “wall of wire” during the upcoming regulatory period, obviating the need to incorporate such a factor in the next regulatory period.
- 60 Although the potential future introduction of an I-factor may be a welcome development, it will do little to improve incentives overall unless there is clear guidance from the Commission regarding its future intentions as to the regulatory treatment of future capital expenditure, whether by means of addition to a well specified asset valuation regime, or rewarded through a properly developed S-factor scheme.
- 61 To foster efficient conduct, the Commission must provide EDBs with a clear understanding not only of how the *current* threshold/price path will be set, but also of how a price path would be *reset* in the *future*. In particular, without a clear framework for the valuation of assets, or for quantifying the rewards that will arise from increased efficiency, EDBs’ incentives for efficient investment and operating decisions will be weakened and distorted. The potential incorporation of an I-factor is somewhat trivial when set alongside these fundamental issues.

Quality

- 62 The Commission has proposed significant changes to the quality threshold. Whereas the existing quality threshold simply requires no deterioration in quality, the new threshold is intended to incentivise EDBs to improve quality and reliability of service through the inclusion of a positive S-factor in the price threshold. In addition, the Commission has proposed to shift the consumer engagement criterion from the quality threshold to the information disclosure requirements.
- 63 In determining the applicable S-factor, businesses will first be grouped together based on common characteristics, then further grouped based on their relative quality performance. Businesses that perform poorly compared to their peers are to be assigned a positive S-factor on the basis that improvements in quality require increased investment. Businesses

that perform well will also be assigned a positive S-factor to provide a reward to those businesses, and also to provide averagely-performing businesses with an incentive to improve their performance.

- 64 Orion sees several problems with these proposals. First, the Commission has accepted PBA's study that groups EDBs based on characteristics such as ICP density, network structure and percentage of network undergrounded. However, although these "supply side" network characteristics play a role in determining quality requirements the driving factors for quality improvements are "demand side" characteristics stemming from customer requirements and demand for reliability.
- 65 By way of example, two networks may have similar *average* densities, but the proportion of different types of customer (business, residential, rural, irrigator), and consequently their reliability requirements, may be very different. Standardising quality across groups of EDBs based on subjective characteristics may result in some groups of customers being charged more than their willingness to pay for a level of reliability that exceeds their requirements.
- 66 Furthermore, the asymmetric nature of the S-factor (the S-factor is only positive) seems likely to provide perverse and unintended incentives for EDBs. This stems from the Commission's use of a "carrot and carrot" approach rather than the usual "stick and carrot" approach, ie, poor performing businesses are rewarded with a positive S-factor, as are well performing businesses. It is difficult to assess this somewhat novel approach without knowing further details regarding how the scheme would work, such as:
- 66.1 whether EDBs in the above average group would continue to receive a positive S-factor if they did not change their performance;
 - 66.2 whether EDBs in the poor performing group would continue to receive a positive S-factor if they did not change their performance; and
 - 66.3 what the consequence would be of an average performing business worsening its performance.
- 67 Furthermore, the Commission has not provided any indication of the likely magnitude of the S-factor, or suggested a methodology for determining the S-factor. On the face of it, without these details, it would seem that average performers have just as much incentive to *worsen* their performance as they have to improve it, so as to achieve a positive S-factor in the subsequent regulatory period (remembering that incentives

operate through changing future outcomes as a consequence of near term conduct). Similarly, EDBs in the poor performing group do not obviously have an incentive to improve their performance, since this may result in them losing the S-factor as they move from poor to average performance.

- 68 Consequently it is difficult to provide comprehensive comments on the appropriateness of the S-factor absent any meaningful understanding of how it might work in practice.
- 69 Thank you for the opportunity to make this submission. If you have any questions relating to the submission, please contact Dennis Jones (Industry Developments Manager) DDI 03 363 9526 email dennis.jones@oriongroup.co.nz.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'Rob Jamieson', with a large, sweeping flourish underneath.

Rob Jamieson
General Manager

RESPONSE TO THE COMMISSION'S QUESTIONS

Preface

The following answers to the Commission's questions should not be taken as implying Orion's acceptance of the Commission's preferred approach. Please refer to our main submission for Orion's view of the Commission's proposal.

Orion believes that, as a whole, the Commission's Discussion Paper is insufficiently developed and does not provide adequate details to answer many of the questions posed. Several of the questions are very broad in nature and are particularly difficult to answer given the uncertain context of this threshold reset, ie, the possibility that the thresholds will be transitioned to a control regime.

Chapter 2: Regulatory Framework and Principles

1	Do respondents agree with the Principles as set out? Are there any other relevant principles?
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Orion notes in our main submission that the Commission has removed a previously key criterion from its principles that highlighted the critical distinction between developing a price path under a threshold regime as compared with a control regime. Orion is of the view that, if the reset thresholds are to be transitioned to a default price path (which is clearly contemplated by the Cabinet Paper and the Commission itself), the principles must reflect the very different requirements for developing a control regime. For further details refer to section B of our main submission.

2	Are there any other significant trade-offs between the Principles? If so how can they be best addressed?
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There will inevitably be trade-offs between the various principles contained in the Discussion Paper. Consistent with Orion's submission to the MED during the review of Part 4 and 4A, we consider trade-offs can best be managed by incorporating an overarching objective that emphasises the need for all decisions under Part 4A (or a revised Part 4A) to be consistent with the promotion of efficiency for the long-term interests of consumers in New Zealand.

Chapter 3: Threshold Arrangements

3	Do respondents agree with the Commission's initial view that the arrangements should consist of two main thresholds, one focussed on price and the other on quality?
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Yes.

4	Will the Purpose Statement and Principles be better achieved if a quality focussed threshold for the period 2009 to 2014 is developed with the proposed objective in mind?
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Orion agrees that EDBs should have the incentive to improve reliability performance to the extent that customers demand it. However, Orion has reservations about the Commission's proposal to separate EDBs into peer groups. For more detail refer to our answer to question 29.

Chapter 4: Efficient Operation of EDBs

5	Do respondents consider that retaining the B-factor is consistent with the Principles?
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Orion considers that a B-factor is consistent with the Principles and is appropriate under both a threshold and a control regime. However we do not believe that the methodology used to derive the B-factor is consistent with the robustness principle. For further details refer to paragraphs 42 and 43 of our main submission.

6	Which of the two initially considered approaches are most appropriate when seeking to incentivise EDB productivity and profitability performance? Are there other approaches which should be considered?
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Neither approach is appropriate. A key requirement for incentivising efficient investment, and so improved productivity, is providing businesses with sufficient certainty that a reasonable return on those assets can be earned into the future. Without knowing how investment in assets that underpin service delivery will be remunerated, or how changes in asset values will be reflected in regulated prices over time, incentives to undertake efficient investment will be weakened.

7	Do respondents consider that the use of a price (P_0) adjustment in the first year of the regulatory period, to account for unsustainably low or excessive profits, would be more consistent with the Principles than retaining the existing arrangements?
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Neither approach is appropriate. The purpose of a P_0 adjustment is to “level the playing field” and ensure all businesses are earning normal rates of return. If the P_0 adjustment is undertaken using the same benchmarking methodology as adopted for the C_2 factor, it is highly unlikely that any business will be earning normal returns since the methodology used to determine the C_2 factor bears little, if any, relation to the actual or efficient costs incurred by EDBs. A P_0 adjustment can only result in a consistent starting point for all EDBs if a form of building blocks approach is adopted. For further details refer to section C of our main submission.

Furthermore, as described in paragraphs 51 and 52 of our main submission, the methodology used by the Commission for calculating the C_2 factor is not robust. A P_0 adjustment based on the same methodology will be subject to the same inaccuracies.

8	Do respondents consider that a P_0 adjustment can be used to account for differences in relative productivity? Is this more applicable for better performing EDBs? Do respondents consider that a glide-path approach such as the current C_1 factor may be more appropriate for poor performing EDBs?
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Neither approach is appropriate. As above, Orion would not support a P_0 adjustment calculated using the same methodology adopted to determine the C_1 factor. The C_1 factor calculated using MTFP – or a P_0 adjustment using the same approach – is not sufficiently robust for the purpose of establishing price paths. Refer to paragraphs 45 to 50 of our main submission for details.

Chapter 5: Investment Incentives

9	To what extent are specific regulatory investment provisions necessary to achieve increased reliability performance?
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Orion agrees that the regulatory regime should provide EDBs with incentives to achieve increased reliability performance. However, the Commission has provided insufficient detail of what these provisions might entail to enable us to comment at this time.

10	Other than the thresholds themselves, do current regulatory obligations affect investment decisions of EDBs, if so, how do they affect investment decisions? How can these be accounted for appropriately within the thresholds?
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There are a number of existing regulatory obligations and proposed changes to legislation and associated regulations that may have a direct or indirect impact on Orion's investment decisions which could potentially impact on our investment decisions or actually limit our investment choices such as:

Changes to the Electricity Act including the implementation and maintenance of safety management systems, restrictions on performing proscribed electrical work, registration and licensing requirements potentially create an increased risk of Orion breaching the Act;

Proposed Safety Regulations with an overarching objective of providing for the protection of the health and safety of members of the public in connection with the supply and use of electricity; and to promote the prevention of damage in connection with the supply and use of electricity.

Land Transport Amendment Bill and the proposed National code of practise for utilities access to road and rail corridors. These set out the government's objectives in relation to utilities access to road and rail corridors and include the right to access these corridors while placing reasonable conditions upon entry to utilities.

The changes to the *Land Transport Amendment Bill* and the proposed *national code of practise for utilities access to road and rail corridors* alone will add an estimated additional 30% to the cost of cable laying in Orion's area as a result of the proposed changes to the depth at which cables must be laid.

Recent changes the tree regulations are also estimated to increase costs by an additional \$1 million per annum.

These together with existing Health and Safety legislation, EIRA, local government requirements, and the RMA all add significant costs which ultimately impact on investment decisions.

This is compounded by the differential between the ODV handbook values and the actual cost of new investment immediately results in an undervaluing of that new investment. Despite these issues Orion as a responsible company have continued to invest in our network as required despite our concern that we will not make an adequate return on our investment over the life of the assets

11	Should the regime take into account differences between businesses (e.g., locational or scale)? If so, what differences would it be appropriate to take into consideration and why?
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The Commission has not provided sufficient details on how these differences would be taken into account to enable us to comment at this time.

12	Do respondents have any views on the Commission's expectation that load growth related investment will, in general, be self-financing and ordinarily should not require specific regulatory provisions?
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Whether or not load growth is likely to be self-financing (at the existing average price) depends upon whether the marginal cost of serving that growth is above, below or the same as the average cost of serving current load. As a matter of principle there are many reasons why the marginal cost of growth might be different from and most likely greater than current average cost. These include:

- disproportionate growth in the fringe areas of the network, which involves higher costs due to its greater sparsity; and
- increases in the unit replacement cost of assets that have not been reflected in price changes for existing customers - such as the industry is experiencing at present following the sharp increases in base metals prices in the context of the resources boom.

It follows that in order to ensure adequate incentives for network investment to meet load growth, there must be a fully developed framework for addressing the question of how to value both existing and new assets, and how these values are to be updated over time to reflect additions and subtractions arising from new investment and depreciation.

13	Do respondents have any views on the Commission's expectation that renewal investment will not be self-financing?
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Orion agrees with the Commission that renewal investment will not be self-financing.

14	Do respondents agree that the lack of accurate and complete information, as highlighted in FSC (2007), makes effective analysis and forecasting of future investment difficult? How can such information shortfalls be addressed?
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We have not carried out an in-depth analysis ourselves of the FSC (2007) ourselves we understand that the ENA will be making a more detailed submission on this FSC paper.

15	Have the thresholds had an impact on replacement investment? Are there views as to the reasons for the apparent reduction in 2006?
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Orion does not have a view on this issue.

16	Do respondents have any views on the FSC (2007) assessment that the New Zealand electricity industry does not face a large imminent increase in renewal based investment ('wall of wire' effect)?
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We leave comment on this issue to the ENA on behalf of the industry.

17	Do respondents have comments on the assessment of relative renewal needs of EDBs (Table 7) during the forthcoming regulatory periods?
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Refer to our answer to question 16.

18	Is a mechanism to provide incentives for additional investment expenditure appropriate within the threshold arrangements, if so, for what reasons?
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It is important for any regulatory regime that sets limits on prices to incorporate mechanisms that ensure businesses have sufficient funding to undertake efficient investment. Incentives for efficient investment are essential for fostering dynamic efficiency and the reduction of costs over time, for the long run benefit of customers. However, no mechanism will provide such incentives without also ensuring EDBs have sufficient certainty that the additional investment will appropriately be rolled into the RAB, or otherwise fully reflected in forward-looking prices so as to ensure a normal risk adjusted return on investment. Refer to section C in our main submission for further details.

19	Is there sufficient scope within the existing arrangements to account for increasing renewal investment?
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No. The thresholds do not take into account the need for investment. If an EDB undertakes necessary renewals investment and in doing so breaches its threshold, there is no guarantee that the Commission will then take account of the requirement for a reasonable rate of return to be earned on that investment going forward. Moreover, the costly, time-consuming nature associated with the potential administrative settlement process is similarly uncondusive to undertaking increased renewals investment.

20	If a specific investment allowance mechanism were to be introduced in 2009, what is the most appropriate form for such a mechanism?
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Refer to our answer to question 18.

21	The Commission welcomes views on the proposed I-factor mechanism and whether such a mechanism is best introduced from 2014?
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Refer to our answer to question 18.

22	Do respondents consider there to be any other approaches that have not been considered that may incentivise efficient investment?
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Refer to our answer to question 18.

23	Do respondents agree with the Commission's initial view that if an investment incentive mechanism is introduced it should be underpinned by some form of explicit accountability mechanism and if not, why?
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Orion's initial view is that if an I-factor (or similar mechanism) were to be introduced it would be difficult, in practice, to put in place an explicit accountability mechanism capable of distinguishing between legitimate out-performance brought about through improved capital efficiency and deliberate or otherwise unjustified capital underspending. We note that the Commission recognised this potential challenge in its Draft Decisions for the control of Powerco and Vector's gas distribution services, and consequently opted not to incorporate such a mechanism.

24	Do respondents have any comments on the Commission's initial view that an accountability mechanism should apply from the beginning of a regulatory period rather than within a regulatory period?
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Refer to our answer to question 23.

25	What do respondents consider to be the most appropriate method of providing investment accountability and why do respondents consider that method to be appropriate?
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Investment accountability is best provided by ensuring that effective ex-ante investment planning and approval processes are in place, together with clear incentives to undertake investment in the most efficient manner.

Chapter 6: Quality

26	Do respondents agree that the reliability criteria should be set using normalised data?
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Orion agrees that normalised data should be used to set the reliability criteria.

27	Do respondents have any views on the proposal to use a three-year moving average to address the effect of normal variability?
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Orion agrees that a three-year moving average should be used.

28	What are respondents' views on the proposal that the reliability criteria be applied separately to networks that are either non-contiguous and/or that have ownership/beneficiary differences?
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Orion agrees there may be merit in implementing separate quality thresholds where a single EDB owns more than one geographically non-contiguous network. The networks operated by Vector, Aurora and Powerco are salient examples. However this should not extend to networks that are electrically non-contiguous but geographically adjacent. By way of example, although Orion operates in a single geographic area, we own four electrically non-contiguous networks. It would not be appropriate for Orion's four adjacent (albeit electrically non-contiguous) networks to have separate quality thresholds.

Orion has no view at this time on whether networks that have ownership or beneficiary differences should be subject to separate quality thresholds.

29	Would the establishment of characteristic based peer groups allow for the better comparison of EDB reliability performance?
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As we discuss in the main part of this submission, the C_1 factor is not sufficiently robust to reasonably apply to the price threshold. NERA has argued that a single X-factor would be more appropriate than the existing three narrower, less reliable C_1 factor measures. Further disaggregation of groupings of EDBs and an increased number of C_1 factors can only serve to exacerbate the unreliability of these measures.

Furthermore, all EDBs differ to some extent. Some businesses that have comparable degrees of, say, undergrounding, may have materially different ICP density, and so on. Assigning weights to the various factors would likely prove particularly challenging. A further critical factor that influences

the level of reliability services standards that does not appear in the Commission's criteria is the composition of final users (eg, business, residential, rural etc) and the level of reliability demanded.

In sum, Orion envisages that it will prove challenging to construct a set of criteria that are mutually exclusive and collectively exhaustive and consequently to group EDBs on a "like-with-like" basis.

30	Do respondents have views on potential characteristic based grouping criteria (e.g., ICP density, network structure and percentage of undergrounding/urban network)?
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Refer to our answer to question 29.

31	Would the establishment of reliability performance based bands within the groups allow for the better targeting of incentives? Do respondents consider the proposed averaging methodology is an appropriate basis for this?
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Absent further details, including the manner in which such bands would be established, the breadth of such bands and the underlying grouping characteristics (refer to question 30), it is not possible at this time to anticipate whether the proposal, including the averaging methodology, will achieve the stated objective.

32	Would requiring EDBs to improve their relative reliability performance be more reflective of the pressures that firms would experience in a competitive market?
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In a competitive market, businesses respond not only to what their competitors are doing (the 'supply side') but what their customers demand (the 'demand side'). Requiring EDBs to improve their relative reliability performance addresses the first, but not the second. To the extent that customers are charged more than their willingness to pay for a level of reliability that exceeds their expectations, then this measure would not be consistent with a competitive market outcome.

33	Do respondents have views on providing a positive adjustment to the price-path of the below-average performers to reflect their scope to significantly improve reliability? Do respondents have any views on an approach that would make receiving a positive S-factor adjustment conditional on EDBs providing evidence that sufficient investments have been made to warrant the adjustment?
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The Commission has provided insufficient details for Orion to answer this question at this time. However, we have concerns about the incentives resulting from an asymmetric S-factor. For further details refer to paragraphs 62 to 68 in our main submission.

34	Do respondents consider that introducing an S-factor to the price-path, as outlined, will provide sufficient incentive to encourage average performers to further improve reliability? Should EDBs who improve their reliability sufficiently receive an S-factor in that regulatory period or the subsequent one?
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Refer to our answer to question 33.

35	Which of the two options proposed for the above-average performers (as outlined above) do respondents consider to be most appropriate?
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Refer to our answer to question 33.

36	Would it be appropriate to provide different incentives for below-average performers, average performers and above-average performers in the different peer groups. For example, should an above-average performer in a high-density peer group receive a different incentive than an above-average performer in a low-density peer group?
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Refer to our answer to question 29.

In addition, applying different incentives across different peer groups implicitly implies a comparison between different characteristics, exactly what the Commission is attempting to avoid by grouping EDBs in the first place.

37	Do respondents consider that the implementation of updated reliability criteria, possibly complemented by service quality incentives (section 6.5.1), would promote the objectives of the Purpose Statement and fulfil the Price/Quality Trade-off Principle?
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No. The Commission's proposed revised quality threshold is not sufficiently well thought out to promote the objectives of the Price/Quality Trade-off Principle. For further details refer to paragraphs 62 to 68.

Furthermore, the critical question is whether or not the Price/Quality Trade-off Principle facilitates increases in prices when service quality (and so costs) increases, and vice versa. The Commission's proposal to increase

prices both where service quality is high *and* low would not appear to meet this criterion.

38	Do respondents have any comment on the Commission's initial view that the monitoring of consumer engagement should be transferred from the quality threshold to Information Disclosure?
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Orion is in favour of consumer engagement in relation to quality and reliability issues and considers that this is an important part of an EDB's operations. We consider that transferring the monitoring of consumer engagement from the quality threshold to Information Disclosure would be a reasonable approach.

39	Do respondents agree with the list of service quality criteria set out above? Should further criteria be considered? Do respondents have any views on the availability and collection of information relating to these criteria?
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Orion does not agree with the list of service quality criteria set out in paragraph 319 of the Discussion Paper. The list is vague and none of the criteria are specific, e.g. average time to respond to customer problems – clearly our response time will vary depending on the nature of the problem, with safety issues having priority. We consider that the significant difference in approach between different networks to many of the issues raised would make it very difficult to implement a meaningful measure. We have developed our own metrics in relation to a number of the broad categories of issues that are raised in the paper, and while a few may lend themselves to standardisation, we consider that a customised approach based on our individual network conditions and customer requirements is preferable.

40	If implemented, do respondents consider additional service measures should be part of the threshold arrangements or as additional reporting requirements under Information Disclosure?
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As indicated in our response to question 39 we do not consider that standardised metrics are appropriate and should therefore not be implemented in either the threshold arrangements or the information disclosure requirements.

41	Do respondents consider performance reporting at a disaggregated level to be appropriate? Should this be undertaken initially under Information Disclosure?
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Orion sets out in its AMP its performance targets and levels of service in relation to:

- safety;
- consumer service;
- environmental responsibility; and
- economic efficiency

These broad categories include reports on our 10 least reliable rural feeders, power quality issues, our overall policy on losses etc. We consider that AMPs are an appropriate mechanism for disclosure of this information and that any greater level of detail than Orion already provides in its AMP is not required.

42	Would the introduction of guaranteed services level schemes lead to higher service levels for the worst-served consumers?
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The Commission has not given any indication of the scope of any such scheme therefore we are unable to respond as to whether guaranteed services levels would be realistically achievable or lead to higher service levels. There is also no consideration of the additional costs that meeting any higher service level may involve. However, Orion does have a number of guaranteed service levels in place for which a payment may be made to the retailer for failure to meet these levels.

Chapter 7: Refinements to the Thresholds

43	Do respondents consider that the existing definition of excluded services is appropriate? Do respondents consider that any service categories should be added to/removed from the list (appendix D) and, if so, why?
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Orion agrees the existing definition is appropriate.

44	Do respondents agree with the proposed treatment of transmission charges? How might avoided transmission charges be calculated?
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Orion agrees that charges and rebates associated with transmission are largely beyond the control of the EDBs and that there are potential boundary issues between transmission and distribution. We note that assets may transfer in either direction and even new investment

undertaken by the EDB may be a substitute for transmission investment – one of these is subject to pass through while the other is not.

This is a complex area which, when considered in conjunction with the issues around avoided transmission charges from DG, ripple systems etc, needs consultation in its own right. We do not consider that the Commission's discussion has articulated its proposed treatment of avoided transmission charges in sufficient detail for Orion to meaningfully respond.

45	Do respondents consider there to be any particular issues with the pass-through of transmission charges? Do respondents have any views on the proposed approach to address pass-through volume growth?
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Orion has previously responded³¹ to the Commission consultation "*Proposed changes to distribution thresholds gazette notice*" (28 October 2005). In our response we noted a number of fundamental concerns with the proposed methodology. These concerns related to:

1. timing for implementation
2. the proposed method by which distributors might be able to retain the benefit of any previously allowable price increase (or allowable price increase not taken);
3. the apparent proposal to update base weighted quantities; and
4. the proposed method by which distributors should recover or pass back any shortfall or surplus (respectively) between transmission revenue and Transpower charges.

We believe that a number of these concerns are still relevant and still need to be addressed. We therefore consider that it would be necessary to see a firm proposal from the Commission before we could comment further.

46	What measures do respondents consider should be taken to reduce the scope for technical breaches? Given the trade-offs involved, how can any adverse incentives be dealt with?
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Orion considers that some of the Commission's proposed work to address the impact of extreme events and normal fluctuations in SAIDI and SAIFI will assist with reducing the number of technical breaches. However, we believe that technical breaches of any set level will always occur at some

³¹ Orion, *Submission on proposed changes to distribution thresholds*, 25 November 2005.

stage. We consider that a key issue is that the Commission should deal promptly with breaches and in its deliberations take into account:

1. past practice,
2. an EDBs indications of future practice to prevent a reoccurrence of the breach, and
3. the materiality of the breach.

47	Do respondents consider that exemption provisions should be introduced for EDBs achieving a certain level of performance? If so, what criteria would be appropriate?
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The Commission has not provided sufficient information for us to comment on this at this time.

48	Do respondents have views on the current Assessment Guidelines and how the Assessment Guidelines might be improved?
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Orion agrees that, as they stand, the current Assessment Guidelines do not provide sufficient certainty for EDBs and, to the extent that they remain valid, require augmentation. However, if the new legislation is passed, then the Assessment Guidelines may become obsolete in which case the Commission ought to focus its efforts on developing input methodologies.

49	Do respondents have views on the potential introduction of customised thresholds? What criteria would be appropriate in assessing requests for such reviews?
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Orion supports the proposal of customised thresholds in principle. However before customised thresholds can be developed – whether under a new regulatory regime or in the absence of new legislation – there are several issues the Commission must resolve, including establishing an appropriate opening RAB (refer to section C in the main part of our submission) and developing input methodologies.

50	Are there further opportunities for EDBs to address energy efficiency? If so, how might these be accounted for in the threshold mechanisms?
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Orion is constantly looking for opportunities to address energy efficiency. We consider that expenditure on energy efficiency improvements should be treated as a pass through cost.

51	Do respondents consider that any provision should be made within the threshold arrangements to incentivise the reduction of technical losses? If so, do respondents have any views on the form that such an incentive arrangements could take?
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Orion is of the view that although technical losses can be limited to some extent, it is simply not possible to remove them altogether. Electrical losses are natural phenomena that cannot be avoided completely. Orion limits losses by choosing and maintaining appropriate transmission and distribution voltages, and using appropriate conductor sizes that suit our load density. By adopting good industry practice with sound network investment and design principles we have limited our overall estimated losses to less than five per cent of energy delivered.

52	Do respondents have any views on the impact of the current threshold regime on the development of distributed generation and, if so, whether any changes would be appropriate to the current threshold arrangements?
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Orion has no comment on this issue at this time.

53	What demand side measures do respondents consider could be introduced under a thresholds based arrangement, consistent with the Principles outlined in chapter 2?
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Orion has no comment on this issue at this time.