



Submission on

**Regulation of Electricity Lines Businesses
Implementing Valuation Choice for System Fixed Assets**

Draft Decisions and Discussion Paper

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Part 1: Key Points and Commentary

1. Introduction

Orion has prepared this submission in response to the request in paragraph 22 of the Commerce Commission's draft Decisions and Discussion Paper "Regulation of Electricity Lines Businesses – Implementing Valuation Choice for System Fixed Assets" issued on 24 December 2004 (the "Commission's paper").

Orion's submission is in three parts:

1. Key points and commentary.
2. Answers to questions.
3. Supporting paper by NERA¹ (separate document).

This part 1 develops Orion's view on its preference for the ODV / ODRC method to value system fixed assets and presents the case for rejecting the choice of using an Indexed Historic Cost (IHC) methodology. We then consider some practical implementation issues regarding inflation indices, annual updating and reporting. Finally, we present some of our views on dynamic efficiency.

2. Orion's support for ODV / ODRC

Orion has consistently advocated and supported the ODV / ODRC method for valuing system fixed assets of electricity lines businesses in submissions to, and conferences with, the Commerce Commission during recent years. **It is the only method that properly represents the current costs faced by the average efficient new entrant, a fundamental requirement for the practicable operation of a threshold and control regime that has as one of its objectives that suppliers are limited in their ability to extract excessive profits.**

In response to the Commission's issues paper of March 2002,² Orion comprehensively submitted³ on the basis for valuation methodologies. Pertinent extracts from our submission are as follows:

3. Orion believes that given the predominance of the use of the optimised deprival valuation (ODV) methodology, that the Commission should test any other valuation method against ODV as the counterfactual.
4. Orion believes that line business system assets should continue to be valued using ODV simply because ODV is the only methodology that both promotes economic efficiency and is also tractable and transparent.
11. ... a "sound" valuation methodology should be:
 - coherent with economic theory,
 - transparent,
 - tractable, and
 - consistent with what we observe in functioning markets.
12. The valuation method must be coherent with economic theory in so far as it should reflect how economic theory predicts that the values of capital assets will be formulated in a market with workable competition. Therefore the valuation must produce results that provide investors with incentives not to over or under-invest. Given that most lines business assets are specialised, and do not trade in markets, except as part of a whole line business, the methodology must also be able to develop sensible proxies for the values that would prevail if a market did exist.

¹ NERA, *Comment on the Commission's Valuation Choice Discussion paper*, February 2005

² Commerce Commission, *Issues Paper: The Review of Asset Valuation Methodologies*, 15 March 2002

³ Orion New Zealand, *Submission on Issues Paper: The Review of Asset Valuation Methodologies*, 10 June 2002

13. Transparency is the ability to replicate the valuation methodology and reproduce the value generated in the original valuation. In general, more prescriptive methods are more transparent having less room for discretion and interpretation. Therefore, if a valuation methodology is seen as being too open to interpretation, more prescriptive rules can be applied.
14. Tractability is the ease of application and manageability of the valuation approach. The valuation method needs to be easily applied by valuation professionals, given the available information and the available resources. As well, if the required information is unavailable or the cost of undertaking the valuation is excessive, it is not a satisfactory method.
15. The method must also be consistent with how markets work in practice. The whole rationale of a valuation method is that it should mimic how economic agents determine the worth of an asset or a set of property rights. If the valuation approach returns a perverse result, it is obviously a poor method. Even if the assets being valued are not traded, except as part of a business, the method must produce answers that are consistent with what we can infer about the values of the assets. For example, given the value of the business, what can we infer about the value of the fixed assets?
25. Therefore, Orion believes that the most appropriate valuation method is the one that reflects the utility provided by the remaining service potential of the asset. It is unlikely that historic cost or book value would be close proxies of this. Book value and historic cost are measures of what the assets cost when they were purchased, adjusted for an accounting based amortisation of their remaining service potential, i.e. depreciation.
26. Technological advances, cost structures and replacement costs change through time. Line businesses invest significant amounts in assets where replacement costs are driven by both technological advances and commodity prices. For example, current cable costs are determined by commodity metals prices, plastics prices and the exchange rate. Therefore, book value and historic cost are not good proxies of the value of an asset to a new entrant.
39. Therefore, the most commonly recommended approach for valuing infrastructure assets such as system assets is the depreciated cost of replicating, not necessarily reproducing the assets. This method is now usually referred to as optimised depreciated replacement cost (ODRC). When combined with an economic value test, the resulting set of rules becomes the ODV method.
46. ODV is a key parameter for Orion's business. ODV is used to determine the revenue requirement, to realign the book value of its assets, and to provide the base for the calculation of returns. In commercial terms, ODV establishes the value of Orion's business and provides key indicators. For example, the average age of assets, calculated from the DRV/RV ratio indicates the adequacy of Orion's asset replacement practices. Another example is that the depreciation charge provides a realistic monitor of the appropriate level of capital expenditure on reinforcement. The ODV foundation provides a robust commercial basis for Orion's business.

Hence, ODV / ODRC stands out as the preferred method of valuing our system fixed assets, in Orion's view.

In response to the Commission's discussion paper of October 2002⁴, Orion again comprehensively submitted⁵ its arguments in support of ODRC, rather than Historic Cost (HC), in the context of the pending regulatory threshold-based monitoring and control regime. Two further pertinent extracts from this submission⁵, paragraph 2.2(ii) and Appendix B, are as follows:

2.2(ii) Measuring return on investment

Orion's submission establishes ODRC as the only practicable and defensible asset valuation principle in the context of measuring return on investment. Excess profit could be determined by a comparison of an ELB's ROI with its nominal weighted average cost of capital (WACC), subject to the ROI and WACC being calculated on a consistent basis in terms of risk sharing between consumers and investors.

⁴ Commerce Commission, *Review of Asset Valuation Methodologies: Electricity Lines Businesses' System Fixed Assets Discussion Paper*, 1 October 2002

⁵ Orion New Zealand, *Submission on Discussion paper from the Commerce Commission regarding Review of Asset Valuation Methodologies: Electricity Lines Businesses' System Fixed Assets, Part 1 Overview*, 11 November 2002

Appendix B Cross-references to answers reflecting Orion's view on Valuation Methodologies

Orion recommends ODRC because:

		Refer to question
1.	ODRC meets the evaluation criteria of: <ul style="list-style-type: none"> • coherent with economic theory; • transparent; • tractable, and • consistent with what we observe in functioning markets. 	6
2.	ODRC provides an appropriate asset value parameter for use in threshold testing;	12
3.	Optimisation is compatible with a threshold-testing regime. ELBs are left to make their investment decisions, with known optimisation rules;	24
4.	ODRC provides an appropriate asset value for use in a 'building block' approach under a control regime;	12
5.	A consistent and comparable basis across all ELBs for benchmarking is available;	83
6.	ODRC replicates or mimics competitive market outcomes;	37, 38
7.	ODRC reflects opportunity cost;	32
8.	ODRC is best at promoting dynamic efficiency;	89, 90
9.	ODRC provides a sound basis for pricing;	87
10.	ODRC promotes productive efficiency;	10, 82
11.	ODRC promotes allocative efficiency;	7, 81
12.	ODRC enables meaningful economic depreciation to be implemented;	23
13.	ODV, principally ODRC, was determined and advocated as the appropriate methodology by the Ministry of Commerce in 1994;	35
14.	A radical move away from the established ODV method will result in consternation amongst participants in the market;	
15.	Widespread support by practitioners and professionals;	86
16.	ODRC is expected by investors;	88
17.	Close compatibility with ELB's asset records;	63
18.	ODRC or its near equivalent is generally used in Australia.	62

Orion's referenced questions in this table can be found in the detailed answers in Part II of our submission⁵ (11 November 2002).

It was in this submission that Orion presented its case for ODRC, rather than ODV. Orion considers that the Economic Value adjustment is not appropriate because of Orion's practice in managing investments in extensions where customers choose and fund uneconomic extensions if they wish, and because the regulations prevent lines businesses from disconnecting pre-1993 extensions that are not economically viable. However, the Commission has decided to continue with ODV, which now makes no difference in Orion's case because our EV adjustment is nil and hence ODV = ODRC. Orion continues to refer to the method as ODV / ODRC because we argue, on a principled basis and internationally, that the method is generally ODRC, not ODV.

3. Case for rejection of choice of IHC

Orion considers that there should not be a choice for Lines Businesses to value their system fixed assets using the indexed historic cost method for two principal reasons:

- IHC does not satisfy the valuation criteria for valuing the system fixed assets of a natural monopoly subject to a threshold and control regime.
- Having a choice will introduce unnecessary costs, complications and inconsistencies.

In the following paragraphs, we explain our view more fully.

ODV/ODRC is principled, IHC is not

ODV/ODRC meets the principled criteria that we have listed in the previous section. In contrast, the IHC method does not. The table at the end of section 2 lists the reasons why Orion recommends ODV/ODRC. In contrast, IHC fails to achieve these merits of ODV/ODRC, except for points:

- #3 – If the rules for prudence and efficiency reviews were clearly documented, Line Businesses could make investment decisions, knowing the implications. If these rules were not clearly documented, IHC would also fail on this point.
- #9 – IHC could also provide a sound basis for pricing, but it would still not reflect the costs of the average efficient new entrant.

Inconsistencies with performance comparison

Performance comparisons between lines businesses will become less meaningful if two different valuation methods are used.

HC is not widely used

ODV/ODRC based valuations are used in Australia. Historic cost is used extensively in USA, but regulation has always applied to their electricity industry, not introduced at a later stage, as in New Zealand.

IHC values are not always current

ODRC is the only method of evaluating whether prices are close to economically efficient levels "in real time", changing dynamically as costs change. Unless the indexation and depreciation arrangements operate to deliver an 'ODRC equivalent' value, IHC valuation methods will not track these normal changes in costs.

Futile if result is the same

It is a pointless and wasteful of resources if rules and checks are created for the IHC method to ensure that the result is practically the same as the result obtained from the ODV method.

High cost for IHC Handbook

The cost to produce another Handbook for the IHC method will be high. The Commerce Commission and stakeholders would need to participate in many expensive rounds of proposals and submissions. Orion considers the Commission to be unrealistic in its planned timetable to produce an IHC Handbook 'from scratch' in 5 months (June to Oct 05); refer to the Commission's paper, table 2, p16. The Commission took 10 months (Nov 03 to Aug 04) to update the ODV Handbook from an established Handbook. An IHC Handbook may be expected to be simpler, but there will be plenty of complications with it.

Lack of incentives to Lines Businesses

ODV provides lines businesses with incentives to reduce their installed costs to within the prescribed unit replacement costs. IHC would not achieve this as effectively.

Extra work and costs for Lines Businesses

There would be extra direct work and cost for Lines Businesses to make a choice between two approaches.

Not cost-effective

Considering the above points, if the process is unnecessary and wasteful, it will fail the Commission's own test of cost effectiveness for regulatory criteria expressed in paragraph 50 of the Commission's paper.

High cost to administer

There would be a very high cost to administer an alternative. There would be much greater transaction costs of running a parallel system, including the regulatory costs of resolving issues over ex-poste prudency tests. This is unjustified given New Zealand's small size, especially when the contribution to the NZ consumer's delivered energy cost from distribution and transmission is now a lot less significant (approximately 35%).

4. Inflation indices

Orion agrees with the Commission's proposals and reasoning in relation to indexing, as expressed in paragraphs 146 – 150 of the paper. We disagree with having the choice of using the IHC method, but should this be implemented, we agree that the same indexing should apply to both valuation methods because the index would be applied to effectively the same base.

Orion has provided a detailed answer to Question 1 on the indexing method in Part 2 of this submission. Statistics New Zealand has the basis for a suitable index – the Producers Price Index (PPI) outputs – which results from combining the Labour Cost Index (LCI), the PPI inputs, and the Capital Goods Price Index (CGPI). However, at this stage there is not a published subset of these indices that relates specifically to installed electricity distribution system fixed assets.

Orion recommends that the Commission undertakes the research to find a suitable sustainable index for the industry. If a tailored index is not viable, then Orion would be comfortable with the PPI for all industries, or the CPI for all groups, or an appropriate established subset of these indices.

5. Annual updating and reporting

Orion favours certified ODVs every five years, with annual interim updates. There would also need to be an updated ODV Handbook every five years to update at least the unit replacement costs. Each interim value update would be in four parts:

Base

Apply the inflation index to the latest available result – either the certified ODV / ODRC or the previous updated interim value.

Additions

Add the value of additions since the last annual update at their GAAP-compliant cost to Orion.

Disposals

Subtract the value of disposals since the last annual update, calculated from their quantity multiplied by the prescribed handbook unit replacement costs, suitably indexed for inflation, using the same valuation index, and depreciated according to their age.

Depreciation

Subtract depreciation at the value calculated for the latest certified ODV / ODRC plus the depreciation on additions net of disposals for all interim years since the last certified ODV/ODRC.

The results would be audited and published in a reconciliation statement in the annual information disclosure statement.

6. Dynamic efficiency

Orion has consistently placed significant importance on achieving dynamic efficiency for its business and its customers. This is expressed in our arguments in favour of the ODV / ODRC valuation methodology, and the implementation of our pricing.

In Part 2 of this submission, we answer question 3 in relation to the effectiveness of the ODV vs HC methods to provide dynamic efficiency incentives. This section discusses Orion's views on dynamic efficiency more broadly.

The Commission has explained dynamic efficiency and its relevance comprehensively in paragraphs 119 to 124 and 151 & 152 of the Commission's paper, and also in the Commission's companion paper on information disclosure⁶ (paragraphs 20, 26, 80, 127-129 and 327-329). The key reasons why Orion considers that dynamic efficiency is enhanced if assets are valued under the ODV / ODRC method are as follows:

- (a) The modern equivalent asset (MEA) basis recognises and values only the current technology which would be used by an average efficient new entrant. The MEA is the up-to-date replacement/alternative that would be used by the innovative lines business.
- (b) Optimisation ensures assets are valued only to the extent of the capacity that is required by consumer demand. Any assets that have become redundant are not valued, and nor is any over-capacity.
- (c) Asset values are based on their current replacement cost, adjusted for cost inflation (proposed annually).
- (d) Assets are depreciated linearly over realistic total economic lives. This provides an appropriate representation of their declining value through their service lives.
- (e) The modularity of the ODV / ODRC method enables subsets of asset values to be readily obtained for other purposes such as values or returns by area, or to calculate incremental capital costs.

None of these attributes apply with the IHC approach to valuation unless the Commission implements comprehensive prudency and capex efficiency reviews, and a depreciation regime that takes account of changes in utilisation/redundancy.

⁶ Commerce Commission, *Review of the Information Disclose Regime Discussion paper*, 24 December 2004

Orion acknowledges dynamic efficiency as the manifestation of allocative and productive efficiency in 'real time'. Via ODV / ODRC, assets are valued according to current costs and appropriate returns (allocative efficiency), and the assets that produce the service at the desired quality are valued at their efficient minimum cost (productive efficiency). These attributes give rise to appropriate prices for the services provided.

7. Dynamic efficiency and pricing

The cost of Orion's electricity delivery service is primarily determined by its investment in system fixed assets. Consequently, their value is the prime fundamental parameter behind Orion's line pricing. The key part of Orion's pricing is the peak delivery component. This results in a charge to our customers (retailers and major customers) for their power loading during the periods when we have peak loadings on our network. Our investment in our network is primarily determined by the need to maintain our delivery service during times of peak loading.

Orion's line price for peak loading is derived from estimates of long-run average incremental cost (LRAIC) of servicing consumer demand at times of network peak loading which, in turn, uses the optimised replacement cost (available from the ODV / ODRC), taking account of the portion of this investment which is load-dependent.

The resulting price is forward-looking and dynamically efficient because it represents the current marginal cost to deliver electricity at peak loading (allocative efficiency) and also its minimum capital cost (productive efficiency). Properly used by our customers, this enables them to choose between purchasing the service from Orion, or meeting their needs in some other way (eg demand side management, an embedded generator or alternative energy source). It is only when pricing is implemented this way that the pricing / charging for Orion's service, as a natural monopoly provider, can be implemented appropriately. ODV/ODRC ensures that the resulting valuation and depreciation inputs to our pricing model are relevant and reasonable estimates of what a current efficient new entrant would have to pay to replicate the network. The IHC method would not directly provide this facility (ie it would not directly provide an undepreciated optimised replacement cost).

8. Conclusion

There is no need for a choice in valuation methods. Moreover, a choice in valuation methods would be a disadvantage. Orion's considered view is that the ODV / ODRC method, suitably indexed annually for inflation, provides what the NZ electricity distribution and transmission industry needs to value its fixed network assets because it represents the costs experienced by the current efficient new entrant. The ODV / ODRC method is coherent with economic theory, transparent, tractable and consistent with what we observe in functional markets.

In contrast, the IHC method is unprincipled, will introduce inconsistencies with performance comparisons, and would incur a high cost to implement and administer, ultimately introducing extra work and costs for all concerned, for little benefit. While the resulting values can be adjusted for inflation, the Commission would have to introduce considerable complex procedures for prudence and efficiency reviews of capital expenditure.

Orion agrees that the dynamic efficiency of lines businesses is important, and considers that the ODV / ODRC method of valuation provides the appropriate basis for measuring and managing dynamic efficiency, with respect to returns and pricing. The IHC method cannot achieve this without considerable adjustments, for which the Commission would have to create a complex set of comprehensive rules.

Orion has provided detailed answers to the questions in the Commission's paper in part 2 of this submission.

Part 2: Answers to Questions

Question	Answer
<p>Question 1. Valuation updates: What views do you have on the need and proposed process for undertaking annual updates of regulatory asset valuations using the ODV and HC methods? What method should be used to index values in this annual process?</p>	<p>Orion supports annual updates of ODV, on an indexed basis, together with a full certified ODV at least every 5 years, subject to any material changes in business circumstances, as proposed in paragraph 138 of the Commission's paper. The materiality change test for the current 3-yearly requirement is 10%. For a 5-yearly basis, this should be extended to 15%. While the process would not track asset replacement costs precisely, the trend would be in the right direction and the step change in values at the end of the 5-year period would be minimised. This approach would be more cost-effective as the cost of the full ODV determination would occur only every 5 years, not 3 years, as at present. It would also be useful if ELBs could choose to undertake a full ODV during the interim years, if they wished.</p> <p>Orion could establish an indexed result simply by applying the index to the unit replacement costs within its established ODV (eg ODV at 31 March 04) and then re-running its valuation model with an updated valuation date. This would accurately translate the established value into a future value (eg 31 March 04 ODV to its corresponding value at 31 March 05). This process would fully take account of changes in depreciation resulting from additional aging. An appropriate underlying rule for this approach would be that the ELB can adjust only the unit replacement costs, and not any other parameters (eg estimates or optimisation). Refer to the answer to Q2 for dealing with capital expenditure and asset disposals.</p> <p>For Orion's view on the annual ROI calculation, please refer to our answer to question 17 of Orion's submission on information disclosure⁷.</p> <p>As explained in Part 1 of our submission, Orion does not favour the choice of IHC, but if this becomes a choice, we agree that the asset base should be indexed.</p> <p>The indexing needs to reflect changes in the installed costs of assets. In section 2.4.2, of Orion's Valuation Report⁸, our main asset groupings are Cables (42% of ODV), Lines (16%), Transformers (13%) and switchgear & miscellaneous (29%). An installed cost index for each of these asset groups would be ideal, but probably not feasible. The cost to provide such indices would be prohibitive. The index needs to be readily available and either already established or be developed. Either way, it must be available for the foreseeable future.</p> <p>Orion recommends that the Commission finds a suitable index that is based on input costs incurred by the electricity distribution industry to install fixed assets. With a skills squeeze, increased safety compliance costs and increased infrastructure spend likely over the 20 years, our index could be higher than CPI. An alternative would be a producer's price index (PPI, outputs) that applies to the electrical contractors that install our assets on a turnkey basis.</p> <p>The fallback would be for the industry to use the established PPI for all industries or CPI for all groups or one of their subset indices.</p>

⁷ Orion NZ Limited, *Submission on Review of Information Disclosure Regime Discussion Paper*, 14 December 2004, dated 25 February 2005.

⁸ Orion NZ Limited, *Report on Optimised Deprival Valuation of System Fixed Assets as at 31 March 2004*, issued 7 December 2004.

Question	Answer
<p>Question 2. Capital expenditure reviews: What frequency and process should be used to implement capital expenditure reviews for the roll-in of expenditure under the HC method? What capital expenditure reviews, if any, do you consider are required in intervening years for those lines businesses that use periodic ODV valuations? What comment do you have on the need for and scope of prescriptive guidelines for capital expenditure reviews, similar to those used for optimisation under the ODV method?</p>	<p>Going forward, Orion supports only ODV and advocates that capital additions during the intervening years be valued at their GAAP compliant replacement cost, with suitable indexation in subsequent years, without expenditure reviews. This is a pragmatic compromise in that the value of any overbuild would be offset by the loss in value of some established optimised assets, which should no longer be optimised out because the load has increased. There would therefore be no need for "independent engineering reviews" (eg refer to the Commission's paper, paragraph 180). All of the ODV Handbook rules would then apply to the capital additions at the next formal ODV revaluation.</p> <p>Orion considers that annual engineering assessments are an unnecessary (and inefficient) cost as all capital expenditure variations get washed-out anyway with the three or five yearly full audited ODV, including optimisation. By definition then, any inefficient capital expenditure remains in the value for about 18 or 30 months, on average, before being adjusted via optimisation or economic value adjustment. In any case a couple of years' overstated capital expenditure will be immaterial to any assessment of rates of return in an investigation/control situation, in Orion's view. Orion also doubts whether capital expenditure reviews would meet the Commission's own regulatory <i>cost effectiveness</i> implementation criteria stated in paragraph 50 of the Commission's paper.</p> <p>Asset disposals, including assets that become stranded, are an issue for Orion. Strandings occur with cables where they are disconnected/isolated but remain on Orion's records for possible use in future. They are, however, excluded from the valuation as the ODV includes only assets in service. Orion would have to track disposals and also calculate and apply the ODV-based value of these to calculate the reduction in value. Effectively, Orion would be creating another 'mini' ODV model to deal with these removals, including strandings.</p> <p>The result would be an interim ODV from 4 parts –</p> <ul style="list-style-type: none"> • indexed base ODV, plus • the value of additions, less • the value of disposals, including cable strandings, less • depreciation <p>The results need to be audited. The auditor may choose to employ an engineering adviser, who simply checks for compliance with the ODV Handbook rules. It would be cumbersome, expensive and prone to error for the Commission to prescribe the requirements for an engineering adviser.</p> <p>If the HC method became an option, Orion agrees that some form of prudence and efficiency reviews of capital expenditure would be required because there is no 3- or 5- yearly wash-up with this approach. They would have to be applied annually, unless there was provision for some form of retrospective optimisation. The rules for the reviews would have to be as complicated as the ODV optimisation rules, in order to achieve the same result.</p>

Question	Answer
<p>Question 3. Valuation-related risks and incentives: In what respect do you consider that the ODV and HC methods are likely to provide effective dynamic efficiency incentives on lines businesses? Do either of the methods produce perverse incentives or significant unmanageable risks?</p>	<p>Dynamic efficiency is discussed in paragraphs 119 to 124 and 151 & 152 of the Commission's paper. Orion considers that, as long as there is appropriate indexing, ODV provides effective dynamic efficiency incentives. The ODV provides a basis for the revenues and returns that the average efficient new entrant would face, over time. As indicated in this paper, and the Commission's other paper on Information Disclosure⁶, the Commission considers that dynamic efficiency is achieved when ELBs have the incentives to, amongst other things, invest in appropriate assets, over time. (Paragraph 80⁶). Orion considers that the ODV method inherently provides ELBs with the correct incentives to invest in appropriate assets. ELBs know that an asset's value is not included if it is not required for the delivery of electricity, or if their capacities are excessive. However, there are commercial risks, particularly if the regulator sets unreasonable rules, such as unrealistically short planning periods for optimisation, or ignores some real cost assets (eg Easements). Except for a few exceptions, such as these two issues, Orion considers the existing Handbook rules to be reasonable. Orion is not aware of any perverse incentives for investment, either in the ODV method generally or in the present Handbook rules.</p> <p>The ODV is also a key source of information for the LRAIC (Long-run average incremental cost), which Orion uses in its pricing, for dynamic efficiency. Set at the correct level, this provides users of Orion's delivery service with the appropriate choice of either purchasing the service (generally taking supply at times of Orion's peak loading) or meeting their needs via other, lower cost alternatives, over time. This price moves as the costs and loading levels move. It also enables Orion to provide credits for export from embedded generators at the correct levels, using the same principles. This practice ensures appropriate allocative efficiency.</p> <p>Given that the suggested IHC method would have a similar set of rules with prudence and efficiency reviews, there would be similar incentives for dynamic efficiency, although the basis is unlikely to be as clear. On a year-by-year basis, there cannot be the same consideration of asset capacity utilisation with IHC as is available through ODV on an integrated basis every 3 or 5 years. Further, IHC could provide ELBs with a perverse incentive to underbuild, leading to inappropriate assets which would eventually end up costing more.</p>
<p>Question 4. Valuation compliance costs: Do you regard the compliance costs of the ODV and HC methods as being similar? What features of an ongoing valuation approach will best assist in minimising ongoing regulatory asset base valuation costs, while still meeting the Commission's requirements under the Act?</p>	<p>First, Orion considers strongly that regulatory compliance costs will be minimised by retaining the one established valuation method - ODV. The five yearly cycle with interim indexed ODVs will also reduce costs compared with the present three year ODV cycle.</p> <p>Second, Orion considers that the compliance costs for the two approaches would otherwise be similar. The cost to produce a full certified ODV is high - probably \$300,000 to Orion for the 2004 ODV.</p> <p>Clearly, there would be considerable additional costs in setting-up the alternative choice of IHC. It would involve many parties in additional costs through the consultative process.</p> <p>Features that will keep costs down are:</p> <ul style="list-style-type: none"> • use of a readily available inflation index • minimal need for auditing and/or engineering assessments • maximum times between full valuations

Question	Answer
<p>Question 5. Implications of mergers and acquisitions on valuations: How should regulatory asset values best be adjusted to deal with the effects of mergers or acquisitions of lines businesses? What views do you have on the proposed process for allowing lines businesses to change their valuation method?</p>	<p>The issues and implications of mergers and acquisitions with mixed valuation methods disappears if there is no choice of valuation method and only ODV is used. Orion agrees with paragraph 164 of the paper in that the regulatory accounts of the acquirer should initially reflect the regulatory values of the acquired business' regulatory balance sheet. Please also refer to Orion's answer to question 10 in the Commission's Information Disclosure issues paper.</p> <p>If there is to be a valuation choice, Orion agrees with the Commission's proposals in paragraphs 169-171.</p> <p>Regarding paragraphs 165 & 166, Orion is unsure how the interests of both the investors and the consumers can be protected if different valuation approaches are combined in a merger or acquisition situation or when a lines business is to change method. We doubt whether the differences in values would be "<i>unlikely to be great</i>" (paragraph 166). Even "<i>5 to 10 percent over 5 to 10 years</i>" is material and larger value differences could easily occur. Ideally, neither consumers nor investors should be arbitrarily advantaged or disadvantaged by regulatory asset valuation rules.</p> <p>Further to the <i>time after roll-in</i> issue stated in paragraph 173 of the paper, Orion doubts whether the proposal is practical, as stated in paragraph 168, to categorise expenditure on assets under the IHC method as for the ODV method. Capital expenditure by a lines business is generally by project, involving many assets, which cannot easily be split into ODV categories.</p>
<p>Question 6. Valuation handbooks and guidelines: What further aspects of the regulatory asset base valuation process need to be covered by handbooks and guidelines? In what areas do you consider that there is the greatest need for prescription?</p>	<p>Refer to paragraph 177. Orion considers that, in general, the less prescription, the less the cost to all involved.</p> <p>Orion considers that:</p> <ul style="list-style-type: none"> • the existing prescription is sufficient; • ODV Handbook should remain as a separate stand-alone document; • Existing accounting standards should be used wherever possible; • Maybe there is a need to improve the rules for dealing with revaluations, but this can be dealt with under the changes to the Disclosure regulations; and • The Commission needs to prescribe the rules for interim ODVs.
<p>Question 7. Valuation reporting: In addition to the reporting requirements already in the ODV Handbook, what other information should be reported (for example, in relation to valuation of other assets, valuations using the HC method, updates of ODV valuations and treatments of mergers and acquisitions)?</p>	<p>Only minor changes need be made to the existing reporting requirements in the ODV Handbook, assuming that the alternative IHC method is abandoned. We suggest:</p> <ul style="list-style-type: none"> • No need for rules to report on value of other assets. Use existing accounting standards and GAAP. • Need to prescribe rules for reporting the interim updates of the ODV.