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**Submissions on Revised Draft ODV Handbook
Network Performance Group
Commerce Commission
P O Box 2351
Level 6, 44-52 The Terrace
Wellington
NEW ZEALAND**

Dear Sir/Madam

Efficient New Entrant Benchmark for ELB's ODV Handbook

Orion New Zealand Limited (Orion) has asked NERA to provide a brief comment on the appropriate interpretation of the 'efficient new entrant' concept that underpins the development of the Handbook for Optimised Deprival Valuation of System Fixed Assets for Electricity Lines Businesses' ('Revised Draft ODV Handbook' or 'Handbook').

The efficient new entrant benchmark provides the foundation for the development of the ODV Handbook and its potential application in determining the level of electricity lines business (ELB) revenue below which it cannot be said that an ELB is earning any monopoly profits. It is referred to explicitly at paragraph 1.2 of the Revised Draft ODV Handbook:

The ODV method measures the economic value of system fixed assets to an ELB on the basis that the ELB operates in an efficient manner that is sustainable over time and is not able to extract monopoly rents. To this end the method assumes a hypothetical operating environment where the relevant market is contestable and there are no material barriers to entry into that market by an alternative service provider or efficient new entrant. In such a situation the incumbent ELB's revenue

¹ Commerce Commission, *Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses, Revised Draft for Consultation*, 9 July 2004.

could not exceed the amounts customers would need to pay an efficient new entrant employing a sustainable, cost reflective pricing strategy.²

Orion's submission in response to the Revised Draft ODV Handbook rightly notes that it is important to be clear on precisely what is meant by an efficient new entrant, since the interpretation of this concept affects:

- the subsequent development of the Handbook and its associated 'standard unit costs';
- the point at which an ELB's revenues may be deemed to include an element of monopoly rent;
- decisions that may potentially be taken by the Commerce Commission under the threshold and control regulatory regime; and
- the strength of the incentives on ELBs to invest in the development of their networks.

The first of these issues has already become apparent in the consultation process in relation to the Revised Draft ODV Handbook. Orion and other submitters have made the point that the standard replacement costs should not represent the maximum theoretical level of productive efficiency, as mandated in the Commission's invitation for submissions³ but rather an efficiency threshold that is 'realistically achievable' in a competitive market – as suggested by PB Associates⁴.

Competitive markets and the dynamic process of competition that support them typically involve firms with a range of efficiency performance. The least efficient firms will earn returns that are below their cost of capital and, since this is not sustainable over any long period of time, product market competition will either force those firms to exit, or capital market competition will bring about changes in management. Conversely, the most efficient firms can expect to earn returns that exceed their cost of capital and to sustain such higher returns only for so long as they perform at greater than average efficiency.

By definition, firms that earn returns equal to their cost of capital are of average efficiency. This is because the stock market returns, on which estimates of the weighted average cost of capital are drawn, are derived from observations of ***achieved returns across all firms***.

It follows that the efficient new entrant benchmark must also take as its reference point a firm (or entrant) of average efficiency. This is consistent with the reference by PB Associates

² Commerce Commission, *Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses, Revised Draft for Consultation*, 9 July 2004, para 1.2

³ For example, paragraph 30 of the Commission's 9 July 2004 'Invitation for Submissions' suggests a degree of efficiency that is simultaneously optimised across all possible determinants of cost.

⁴ See: PB Associates, *Review of Optimised Deprival Valuation Handbook, Replacement Costs for System Fixed Assets*, Prepared for the Commerce Commission, 9 July 2004, section 1, p3

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to the need for standard costs to reflect what is 'realistically achievable'. However, it is apparently inconsistent with the reference in the Commission's Invitation for Submissions to standard costs representing⁵:

....the best estimate of the costs that would be paid by an efficient distribution business using the most cost effective methods to establish the optimised design of network, and purchasing all items (equipment and services) at the best possible rates. (emphasis added)

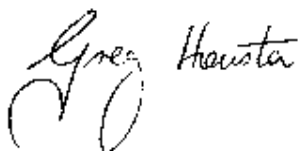
If the efficient new entrant benchmark were to be interpreted as involving a theoretically optimal efficiency performance, the maximum revenues implied by the asset values mandated in the Handbook would not be capable of delivering returns sufficient for the average firm to meet its cost of capital.

Under this interpretation, an ELB would not have sufficient incentive to invest in the development of its network since, at best, it could only ever hope to construct assets at costs equal to standard costs if the ELB was the single most efficient firm in the industry. In most cases therefore, ELBs' expected returns would never be sufficient to meet their cost of capital.

This same principle applies to other elements of the ODV Handbook, such as the length of planning periods used in optimisation. ELBs install assets that last a long time – 40 to 70 years. An efficient new entrant would do likewise. On the basis of the best information available at the time, ELBs plan for the full utilisation of this capacity in due course, which may be 20-30 years out. This reality needs to be recognised when assessing the utilisation of capacity installed by allowing planning periods that would be used by the new entrant.

To conclude, the underlying principles of the ODV method for valuation demand a representation of what is realistically achievable by the new entrant of average efficiency. Establishing replacement costs for assets and the rules for optimisation on the basis of a theoretical ideal is inconsistent with this principle, and will be harmful for incentives to invest in electricity distribution infrastructure.

Yours faithfully



Greg Houston
Director

⁵ Commerce Commission, *Invitation for Submissions on Handbook for Optimised Deprival Valuation of System Fixed Asset of Electricity Lines Businesses: Revised Draft for Consultation*, 9 July 2004, paragraph 30