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06 December 2002

Mr John Belgrave
Chair
Commerce Commission
PO Box 2351
Wellington

Dear Mr Belgrave

RAVM - right of reply

Orion wishes to reply to a number of points raised in last week's conference on asset valuation methodologies. Please also refer to Orion's separate letter on process issues.

1. *Historic cost not used by Orion*

We refer to an email from the Commission to Orion of 3 December and the RAVM Transcript of Monday 25 November 02, p.38, lines 31-50 and p.39, lines 1-13.

The Commission has asked Orion to provide (quote from email) *"information on how long Orion used DHC (Depreciated Historic Cost) after vesting in its accounts, and the date at which Orion moved to ODV in its accounts"*.

Southpower Limited's vesting value was established by an independent valuation on a discounted cashflow (DCF) basis. Subsequently Southpower moved to ODV. The company did not utilise depreciated historic cost.

Southpower first started using ODV in 1990/91 prior to finalisation of the Handbook, based on an expectation of ODV being required by regulation. Work was being performed on the draft Handbook during that time.

The depreciated replacement cost (DRC) value was first calculated by Southpower during 1991, using estimates of replacement cost. This was assessed at \$239m.

Awareness of ODV for pricing purposes, and the impact on prices, grew in 1991 and early 1992, and revaluations took place in 1992 and 1993 based on the valuation of discounted cash flows. It was clearly recognised throughout this time and in subsequent years, that a significant “shortfall” existed between existing prices and those fully reflecting commercial returns on ODV.

Southpower’s first formal revaluation in accordance with the “new” ODV Handbook took place as at 31 March 1994. ODV was the basis of Southpower/Orion’s financial book values for financial reporting purposes from then onwards.

In summary, Southpower Limited was corporatised in April 1993 and the company (now called Orion New Zealand Limited) has never used depreciated historic cost as the basis for valuing its system fixed assets for financial reporting purposes.

2. *How prices were set prior to vesting*

Refer to the RAVM transcript of Monday 25 November 02, p.39, lines 14-43.

Prior to the 1990s, power authorities set prices to recover the bulk supply tariff from NZED (generation and transmission), the cost of any debt, and direct operating expenditure with the intention of making a small surplus, rather than reviewing the adequacy of the surplus. Return on capital was not a significant consideration in price setting.

Prices generally “incremented” previous years’ without a significant re-work of first-principle pricing methodologies. For a period in the mid 1970s accumulated losses were building up in the Christchurch MED’s appropriation accounts. Note that Power Boards and MEDs did not pay dividends and there was no overall imperative to earn a risk-adjusted commercial return on the assets employed.

Retail tariffs were effectively bundled energy and lines prices and were set with considerable political input. Prior to the 1990s, separate line prices did not exist, illustrating the absence of focus on the value of lines assets. Members of Power Boards and Councillors were elected to office. Their political interests resulted in low residential prices and higher commercial prices. A common justification for this was that businesses could claim their energy costs as deductions for tax purposes while households could not.

Also around this time the Energy Companies Act (1992) in s36 stated that *“the principal objective of an energy company shall be to operate as a successful business”*. This was part of a fundamental change in the nature of the organisations, as required by central government, and this

required businesses to consider the level of investment (i.e. opportunity costs) in the company and the adequacy of the returns being generated.

During the latter half of the 1990s, Southpower/Orion's returns have been modest. The regulatory ARP/ROI results for Southpower/Orion (excluding revaluations) were as follows:

1995	1.7%
1996	2.9%
1997	4.9%
1998	5.2%
1999	7.5%

3. Treatment of revaluation gains

Refer to the RAVM transcript of Monday 25 November 02, p.42, lines 19-34.

The discussion between Orion and Commissioners in regard to the accounting treatment of revaluation gains requires clarification:

- a) Orion's financial accounts have never incorporated revaluation gains as income. Revaluation gains have been booked through the statement of movements in equity – consistent with GAAP.
- b) Orion has included revised independent valuations in its statements of financial position since 31 March 1992 (i.e. one year prior to vesting).
- c) Orion has booked revaluations in the numerator of the Regulatory ARP/ROI calculation, as required by the disclosure regulations, from the 1995 year onwards. Therefore, these have been effectively treated as "income". Please refer to Orion's submission (answers to questions 92,93,94,95) for our comments regarding the calculation of disclosed rates of return.
- d) The revaluations which took place in the 1990's reflected a "catch-up" of value which could have been incorporated in prior years if ODV-based pricing had been utilised, as the resulting DCF valuations would have been higher.

4. No need for EV adjustment

Refer to the RAVM transcript of Monday 25 November 02, p.13, lines 9-49; p.14, lines 1-19; p.45 lines 3-49; and p.50, lines 1-27.

Reductions in asset values via EV adjustments can occur on lines in remote locations that have low customer density where there has been considerable investment for the small volume of units conveyed. The

three key reasons, of principle, why Orion considers that EV adjustments are not appropriate are:

- i) Prior to 1 April 1993, ELBs had franchised areas and were legally obliged to build these uneconomic lines. Costs were shared over all consumers.
- ii) Since 1 April 1993, ELBs are legally obliged to retain and maintain these uneconomic lines, established as at 1 April 1993, until at least 31 March 2013. ELBs cannot choose to implement any economic rationalisations.
- iii) For any new uneconomic lines built since 1 April 1993, the consumer(s) who want the extension has chosen to fund any uneconomic portion. Orion properly accounts for this by treating the contributions to asset valuation as income for regulatory disclosure purposes and recognising this when deriving prices.

Consequently, these uneconomic assets need to be included in Orion's assets at their full depreciated value.

The term 'uneconomic assets' is misleading as the consumer chooses to make an investment by capital contribution rather than invest in alternative energy solutions, so that the NPV of the work to the company is non-negative.

Orion also questions whether the resources used to calculate EV for every network would not be better spent on other work. Nationally, the EV adjustment is around 0.3% of value. Orion also notes PB Associates' comments in this regard.

5. Summary of Key Reasons for ODRC

Orion supports the use of ODRC for regulatory valuation purposes as it;

- Is coherent with economic theory and promotes economic efficiency;
- Is a consistent, practicable basis for assessing "excess profits" as it identifies the costs of an efficient new entrant, something historic cost cannot do;
- Allows meaningful comparisons between companies, unlike historic cost, and is therefore consistent with a thresholds scheme;
- Has been endorsed by Government since 1994;
- Is consistent with the requirements of Part 4A of the Commerce Act;

- Is used elsewhere (refer Orion's presentation), particularly for 'threshold' decisions.

Yours sincerely

Chris Laurie
Managing Director