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Regulation Branch
Commerce Commission
Wellington

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STARTING PRICE ADJUSTMENTS FOR DEFAULT PRICE-QUALITY PATHS DISCUSSION PAPER – SUBMISSION

- 1 Orion New Zealand Limited welcomes the opportunity to respond to the Commerce Commission's discussion paper published on 5 August 2010 entitled "Starting Price Adjustments for Default Price-Quality Paths" ("the paper"). As the Commission is aware, due to circumstances beyond our control, this submission is a few days late. We thank the Commission for allowing us extra time to respond.
- 2 Orion's views on the matters set out in the paper can be summarised as follows:
 - 2.1 Orion remains of the view that the process by which starting price adjustments occur should be contained in an input methodology (**IM**) determination.
 - 2.2 The Commission has not explained the test it proposes to use to decide *whether* it intends to exercise its powers under section 54K of the Commerce Act (the **Act**) to reset starting prices.
 - 2.3 The Commission should exercise caution in using historical information to assess what suppliers' "projected" profitability might be, and should explain how it will make such assessments based on historical information.
- 3 Orion has had the opportunity to review the submission on starting price adjustments prepared by the ENA. Orion supports that submission in its entirety and adopts its conclusions as its own.

The starting price reset process should be part of an IM determination

- 4 Orion has previously explained why the process by which the Commission resets starting prices should be the subject of an IM determination.¹ We remain of that view for the reasons previously given, which are echoed in similar submissions provided to the Commission by the Electricity Networks Association (the **ENA**).

No discussion of the test the Commission will use to decide *whether* to reset starting prices

- 5 Section 54K(3) allows (but does not require) the Commission to reset starting prices in specified circumstances. The Commission's paper on starting price adjustments sets out the general framework the Commission proposes to apply when making adjustments.
- 6 However, although the Paper sets out in general terms *how* the Commission intends to adjust starting prices, it does not specify the criteria that will apply to decide *whether* to reset prices. This is a notable omission, since it cannot be presupposed that starting adjustments will be necessary and desirable in all instances. In our view, the Commission should disclose its initial views on this critical matter so that they can be the subject of consultation.
- 7 The Paper is also silent on the approach that the Commission intends to employ to determine whether a published IM "*would have resulted in a materially different path*" under section 54K(3). This represents another area that needs further attention from the Commission in order to facilitate meaningful consultation.

Timing

- 8 Orion notes that the Commission intends to defer further consultation on the starting price adjustments until after the IM determinations have been made.² It also proposes to consult on, and issue any requests for information needed to assist the implementation of starting price adjustments, before 31 March 2011.

¹ See Orion New Zealand Limited, *Submission on Input Methodologies Draft Determination Paper*, 9 August 2010, paragraphs 5.4 to 5.7

² See *Starting Price Adjustments for DPPs Discussion Paper*, 5 August 2010, paragraph 1.13 ("*Starting Price Discussion Paper*")

- 9 Orion has no objection to the suggested timetable, provided that sufficient time is granted to meet the Commission's information requests. Orion can understand why a specific information request might be necessary in circumstances where the new information disclosure IM determination has not come into effect. However, we would encourage the Commission to ensure that such requests are carefully subscribed so as to minimise the cost of compliance.

- 10 As to the proposed timing, Orion notes that the Act requires at least four months between the date a summary is published in the Gazette and the date that suppliers are required to apply the amended section 52P determination. Because these timing requirements do not appear to be expressly addressed in the paper, it is convenient to briefly recap the relevant provisions:
 - 10.1 The Commission may reset the default price-quality paths (DPPs) in accordance with section 53P (i) if an IM is published after 1 April 2010 and (ii) if, had that IM applied at the time the DPPs were originally reset, it would have resulted in a materially different path being set: section 54K(3).
 - 10.2 The Commission may not undertake the reset permitted by section 54K(3) unless it is done within 9 months of the date of publication of the IM: section 54K(4).
 - 10.3 Resetting of starting prices under section 53P is undertaken by way of amendment to the existing section 52P determination: section 53P(1).
 - 10.4 An amendment to a section 52P determination comes into force on the date specified in the amendment which must be a date on or after the amendment, or a summary of it, is published in the Gazette: section 52Q(4).
 - 10.5 Where the relevant section 52P determination applies DPP regulation to a supplier, the DPP does not apply to a supplier until a date at least 4 months after a summary of the determination is published in the Gazette under section 52P(7)(b): section 53M(7).

Current and Projected profitability

- 11 The Commission is ostensibly standing by its previous decision to base starting price adjustments on an assessment of the current and projected profitability of the supplier (under s 53P(3)(b)) rather than to ‘roll over’ existing prices (under s 53P(3)(a)).³ Although that is a legitimate approach, Orion is concerned with certain aspects of the Commission’s proposed approach to assessing current and projected profitability.
- 12 First, there is the practical consideration of the date at which the Commission will assess *current* profitability. We note that the Commission intends to use information from 2009/2010.⁴ While we understand that information for the 2010/11 year will not be available in time to be incorporated in the analysis, this just confirms the backward looking nature of the proposed approach, and further supports the need for caution in determining ‘material difference’.
- 13 The Commission must also ensure that its assessment of ‘projected’ profitability is an assessment of profits that are likely to occur *in the future*. There is a potential tension here between this requirement and the Commission’s stated intention to rely on information that can be readily obtained from suppliers,⁵ historical profitability may be an unreliable predictor of likely future profits. In particular, future expenditure requirements may differ significantly from those that might otherwise be implied by the starting prices.
- 14 We acknowledge the difficulties the Commission has identified in relation to verifying forecasts, and its reticence to engage in qualitative assessments.⁶ We also recognise that a business has the option of lodging a CPP application. However, seeking a CPP is a costly, complex and uncertain process. In consequence, we consider that the Commission should remain open to the prospect of taking into account additional qualitative or quantitative information on forecast profits that a business might wish to provide.
- 15 Indeed, it may be the case that a business facing the prospect of a large price change can provide compelling reasons why projected profits will

³ See *Starting Price Discussion Paper*, paragraphs 1.4, 1.8

⁴ See *Starting Price Discussion Paper*, paragraphs 6.12

⁵ See *Starting Price Discussion Paper*, paragraph 3.19.

⁶ See *Starting Price Discussion Paper*, paragraph 3.20.

differ markedly to historical returns that the Commission can readily accept, without expending significant time and resources verifying the claim. In our view, there is little, if anything, to be gained from precluding this possibility. The possibility that future returns may differ markedly from past is something that is very real for Orion at the moment.

- 16 Finally we note that, while price control under Part 4 is new, price control itself is not. For most EDBs the threshold regime under the old Part 4A sought to limit price increases to around CPI – in Orion’s case CPI minus 1% - for six years. There should therefore be no *presumption* that any EDBs prices were ‘too high’ as at the start of the regulatory period.

Other matters

Expressing revenue adjustments in terms of an allowable notional revenue

- 17 Orion notes that the Commission contemplates that, for the purposes of the price-path compliance assessment formula, starting price adjustments expressed as actual revenue adjustments will need to be expressed in terms of an allowable notional revenue at the start of the regulatory period.⁷ Obviously the exact mechanism for doing this is yet to be developed by the Commission.

Comparative benchmarking

- 18 Orion agrees with the Commission’s view that comparative benchmarking on efficiency must not be used to set starting prices for a DPP.⁸

ROI Band

- 19 Orion agrees that the ROI band should be designed so as to allow for the uncertainty intrinsic in any point estimate of a supplier’s returns.⁹ It may be the case that the band will need to be quite wide so as to accommodate these uncertainties. We are consequently uncomfortable with the Commission’s suggestion that it may subsequently be able to ‘narrow’ the band over time. We do not agree with this logic. The uncertainties associated with relying on point estimates seem more likely to persist over time.

⁷ See *Starting Price Discussion Paper*, paragraph 3.15

⁸ See *Starting Price Discussion Paper*, paragraph 3.16

⁹ See *Starting Price Discussion Paper*, paragraph 4.15

- 20 Moreover, if it turns out that all suppliers are within the band selected by the Commission that does not represent a failing in the approach, or indicate that the band should be narrowed. The objective is not to ensure that some firms lie inside the band and some outside. Rather, it is to assess the range of returns that are appropriate; if all suppliers are within that range that is not a problem. Moreover, tightly distributed returns in one period may be followed by a wide distribution in the next, rendering any narrowing that occurs in the interim premature. In other words the Commission needs to develop a robust method for determining an appropriate ROI band that is agnostic to the starting price adjustments that result from it.
- 21 The Commission has argued that the band should be symmetric around the point estimate, but no justification for this position is provided. We note that:
- 21.1 Price control itself is not symmetric: an EDB whose prices are ‘too high’ must reduce them, but an EDB whose prices are ‘too low’ will not necessarily increase them to the full extent allowable.
- 21.2 Where uncertainty exists, section 52A(1)(a) would suggest erring more on the high side. This is consistent with a number of submissions made on the cost of capital.
- 22 We are also not persuaded by the Commission’s reasoning in using variations in operating expenses as a proxy for variation in ROI. Any measure will have problems associated with it, and we would expect the Commission to understand the impact of the method chosen with respect to other measures. We note that unforeseen events can impact – negatively - on ROI via revenue as well as cost, suggesting ROI variation will be greater than cost variation.

Starting price adjustments should reflect changes requested in relation to IMs

- 23 Any starting price adjustments will ultimately be influenced by the ROI estimates, which in turn will be influenced by key parameters such as the WACC and the regulatory asset base. We have expressed already our significant concerns with the Commission’s draft IM determinations in relation to these matters. In particular:

- 23.1 the Brennan-Lally capital asset pricing model significantly understates the cost of equity for EDBs and produces an unrealistically low WACC point estimate; and
- 23.2 the Commission's proposal to use (partially corrected) 2009 disclosure values to establish the initial RAB is inappropriate – a materially better approach is to estimate a 'fresh' 2010 ODV.
- 24 In order to arrive at an appropriate ROI estimate, and an accurate returns band, the Commission must give effect to these proposed modifications. If the errors in the draft determinations remain, they will manifest themselves in (amongst other things) inaccurate and inappropriate starting price adjustments.
- 25 We re-iterate that it will be no failing of the Commission's approach if it results in no EDB's starting prices being adjusted.
- 26 Finally, Orion notes that consideration of a range of matters relevant to the Commission's starting price adjustment process have been deferred by the Commission.¹⁰ Orion looks forward to an opportunity to present its views on those matters once the Commission's views have been formed.

Concluding remarks

- 27 Thank you for the opportunity to make this submission. Orion does not consider that any part of this submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely



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¹⁰ See *Starting Price Discussion Paper*, paragraph 1.10