

14 April 2014

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FEEDBACK ON SETTING ORION'S CUSTOMISED PRICE-QUALITY PATH

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to provide feedback on the Commerce Commission's (**Commission**) letter seeking "Feedback on setting Orion's customised price-quality path" dated 4 March 2014.
- 2 We appreciate the opportunity to provide feedback on the customised price-quality path (CPP) process. In our comments below we provide feedback on the end-to-end process, which includes both the pre-application process we undertook in preparing our proposal, as well as the Commission's subsequent assessment process after we submitted our application. We do so from a CPP applicant's perspective.
- 3 In our feedback we include some broad observations on the CPP process and also discuss some specific ideas or issues that the Commission may find useful to consider and engage the broader industry and stakeholders on.
- 4 Overall, we believe the CPP process could be simplified, the volume of information required by the IMs reduced and the way the information is required to be provided better aligned to existing EDB practices. This is especially relevant for CPP applications as a result of catastrophic events where resources are better focussed on critical operational tasks. We suggest this is also relevant for "standard" CPPs to avoid a perception (or perhaps reality) that a CPP application is too onerous to contemplate.

Background

- 5 At the time the Canterbury earthquakes occurred in 2010 and 2011, Orion was subject to a default price-quality path (DPP) under the provisions of Part 4 of the Commerce Act. In essence Orion could only increase its prices by the general CPI index each year and in addition was required to maintain historical reliability levels.
- 6 Given that, after the 22 Feb 2011 earthquake, Orion sought to determine how to recover our costs, achieve a fair return on network expenditure and address the ongoing breaches of our reliability limits.
- 7 An obvious option Orion had at the time was applying for a CPP. However, during the latter part of 2010 and all of 2011, our focus was on repairing and restoring the network after the multiple of earthquakes we had, including the well documented significant events of Sept 2010, Feb 2011 and June 2011. We considered a CPP to be an untested, complex, very detailed and resource intensive process – one that would tie up many of our key people at the very time they were needed for our earthquake recovery process. A CPP was not a realistic option for us at that time.
- 8 A further complication was that the DPP and CPP regime was in its infancy and some of the requirements which enable a CPP application to be made were still being set. For example, there were no provisions available to us to apply for a CPP in response to a catastrophic event – the relevant provisions were not gazetted until February 2012.
- 9 As such, we considered another option. We sought an Order in Council (OIC) under the Canterbury Earthquake Recovery Act to address our electricity distribution pricing. The purpose of this was to enable us to step out of the DPP for a period of time, and to recover our earthquake related costs in a timely way including spreading that financial recovery over several years.
- 10 By the end of 2011 we agreed, with the Commerce Commission and the Ministry of Economic Development, drafting on a Memorandum of Understanding (MOU) and were in the process of finalising the drafting for an Order in Council on recovery of earthquake related costs. In essence it allowed us to adjust our prices whilst also ensuring the appropriate checks and balances were in place to ensure our expenditure was reasonable and in line with good industry practice. It also provided temporary relief from the constraints of the DPP quality limits, which we were unable to meet due to damage to the network.
- 11 However, in 2012 we were advised that applying for a CPP in accordance with the Commerce Act was a more appropriate approach.
- 12 While we understand the need for process and scrutiny by a regulator and support that transparency, our initial concerns about the CPP process were

borne out during the CPP process. We did find it complex, time consuming and resource intensive at a time when our resources could be better deployed focussing on the restoration and repair of the network post the earthquakes.

- 13 Below we provide specific feedback on the CPP process we undertook. Orion suggests that the Commission should carefully consider how the overall process can be simplified. The OIC process is illustrative of that, with collaboration between an EDB and government officials, a simpler process can be established.

CPP application

- 14 Given our OIC approach was not accepted, in 2012 we turned our minds to submitting a CPP application. We considered carefully whether we should apply for a full CPP (price and quality), a quality only CPP or remain on the DPP. In this respect we note that the compliance and assessment requirements for a quality only CPP are less developed than those for a full CPP, which introduced additional uncertainties with this option that we needed to consider. Ultimately, in June 2012, our board approved the preparation of a full CPP application.
- 15 A CPP application is complicated, with extensive prescriptive information requirements to comply with. In addition, as ours would be the first CPP application we had no precedent available to us. Further, at the time we began preparation of our CPP proposal in earnest, there were a number of other complicating factors. These included:
- Our CPP would cross two regulatory periods, as it could not be determined until the last year of the DPP regulatory period.
 - The CPP and DPP Input Methodologies (IMs) were not “locked down”.
 - The DPP was to be reset in late 2012, and the reset method for 2012 and ultimately also for the 2015 reset, was not known. Importantly it was not possible to determine Orion’s capex and opex allowances for either DPP reset, or the WACC to be applied in the 2015 DPP reset.
 - The relevant CPP WACC to apply was not known (and not determined until some months later).
 - As a consequence of the earthquakes and the Commission granting us exemption from information disclosure requirements and a s53ZD notice to update RAB values we had not yet established an IM compliant starting position with an initial RAB – which we would need for our CPP.
 - Costs and resource requirements were unknown at a time when much of the business focus remained on earthquake matters and many staff had personal earthquake related issues to address.

- 16 The timeframe we had to complete the application was extremely tight. As the Commission is aware we were required to submit our application by 22 February 2013, being within the 2 year window prescribed. Our application timeline is set out in Attachment A. As you can see from the attachment and as we have conveyed to the Commission in previous discussions and in our proposal itself, we had a very compressed timeframe to prepare our proposal, seek approval from our board, have it verified, reviewed by an engineer, audited, to consult on it- and subsequently finalise it after consideration of the feedback and comments received.
- 17 Of note, on our timeline is the date on which the relevant WACC for our CPP proposal was published. The determined WACC is published annually. The WACC relevant to our proposal was published in September 2012. The IM requirement to complete customer consultations 40 working days before the proposal is submitted obliged us to begin consultation on our proposal by mid November 2012. This 6 week timeframe between publishing the WACC and commencing consultation left little time to finalise our draft proposal, commence the pre-application review processes and seek the relevant approvals noted in paragraph 16 above.
- 18 Such a compressed timeframe supports a review of the extent of the information required to be provided for a CPP application. We comment on ways this could be improved later in this paper.

Verification and Independent Engineer

- 19 Orion's view is that the role of the verifier is a valuable one in ensuring the proposal is of sufficient standard prior to submission. This helped both Orion, in preparing a quality application, and also the Commission in having a quality application to assess, with some direction as to the areas of possible focus during the assessment phase, and increasing the chances of it being accepted for review by the Commission.
- 20 The verifier was not involved to a great degree after we submitted our application. We believe that the process as a whole would be enhanced significantly if the verifier continues to be part of the process after the proposal is submitted. This would ensure the information the verifier has gathered and the explanations the verifier has heard are not lost in the post submission phase of the project. The benefit of this is that the Commission's understanding would be enhanced and repetition (by the applicant) may be avoided, as much of the ground covered by the Commission after the proposal was submitted was the same ground the verifier considered.
- 21 A practical issue is that we found there to be a very limited pool of potential verifiers and unless CPP applications become more common it is unlikely that the number of potential verifiers will grow or have an extensive knowledge of the IMs.

- 22 Additionally, the process of selecting and proposing a verifier for the Commission's approval and then entering into a tripartite deed between the applicant, the verifier and the Commission is itself quite a protracted process. From a timing perspective had the Commission not accepted our proposed candidate it is unlikely we could have met the deadline for submitting our CPP.
- 23 We recommend that the Commission consider options for streamlining the process, possibly establishing a panel of candidates suitable to the Commission that the applicant can select from.
- 24 The verifier had a significant amount of information to review. We believe the scope of what the verifier is required to review as set out in the IMs, with the benefit of hindsight, could be refined further. This would allow the verifier to really focus on topics that are directly relevant to the CPP expenditure objective, which is the primary purpose of the pre submission verification. For example, we do not see a need for the verifier to opine on alternative depreciation, or to consider the price path.
- 25 In addition the IMs require the applicant to present their capex and opex expenditure for the period prior to and including the CPP period by project or programme. The verifier has to examine in detail the largest (in dollar terms) 5 capex and 5 opex projects, the largest 2 (in dollar terms) non system capex projects plus an additional 10 'identified' projects to be chosen by the verifier from the remaining projects. This process is cumbersome and resource intensive for an applicant. As the 10 additional projects to be selected are not known in advance, the extensive IM documentation requirements for each identified project must be completed for all projects, in order for the identified project information to be made available to the verifier in a timely way, particularly given the other constraints on the verifier's process (as illustrated in the timeline attached).
- 26 This process required substantial information to be created and/or manipulated to meet prescribed requirements which were not consistent with our business practices. We combined a number of projects together into logical groupings and we still had 77 projects that needed to be documented (to meet the IM requirements). We note that distribution networks are comprised of many, relatively small value, components which include a broad range of asset types. Most distributors will have a large number of projects and programmes representing the range of opex and capex activities associated with a distribution network.
- 27 We would suggest that this process is revised with the aim of reducing the large amounts of information to be supplied for all projects, and targeting information relating to projects which are representative of the total expenditure plan, and of most relevant to the reasons for the CPP application (ie: in our case the consequences of the earthquakes).

- 28 From a timing perspective the IMs state the verifier must be provided with a full proposal prior to commencing the verification process. Orion suggests that this presents an unnecessary constraint on the verifier's ability to undertake his or her review, as it unnecessarily constrains the time available. A more pragmatic approach, and one which the Commission agreed to in our circumstance, was to permit a drip feeding of parts of the proposal as they were completed. This could be made more express in the IMs. Further to this it is questionable whether the verifier needs the whole proposal. Parts relevant to capex, opex and demand (and potentially reliability) should suffice.
- 29 The CPP process also requires an independent engineer to review the reliability proposals with reference to planned expenditure and statistical analysis. Orion saw this as somewhat of a double up with the verifier's role given the extent of expenditure analysis undertaken by both the independent engineer and the verifier. A simple solution may be to combine the roles.

Audit

- 30 The audit and board certification processes were substantial. This was a challenge for the auditors with the audit of the price path model needing substantial resource to manage, both for the auditors and for Orion.
- 31 In addition, it was not clear what the audit obligations were in respect to the CPP proposal document itself, and other supporting information. Our auditors were not comfortable with the IM requirement for them to opine on whether information had been "accurately presented" as it was not clear what this term required in practice.
- 32 We also note that a large proportion of the information included in a CPP proposal is forecast information. Understandably, there are limits to the extent that this information can be or should be audited. We suggest the focus of the audit should be on verifying actual/historical information, and ensuring that historical and forecast information has been prepared consistent with the IMs.

Consumer Consultation

- 33 The IMs stipulate that the applicant should consult with consumers prior to submitting its proposal and also that the Commission consults with consumers post submission of the application.
- 34 The applicant's obligation for consumer consultation, as set out in the IMs is, amongst some process steps, to "notify consumers of the expected effect" of the proposal on them. The IMs are silent on broader consultation obligations other than the CPP expenditure objective contemplating that a supplier will meet demand "at appropriate service standards". Orion believes it met the consultation obligations in accordance with clause 5.5.1 of the IMs and that previous consultations we had undertaken with the community had enabled us

to understand the levels of service standard our consumers wanted. The Commission expressed a different view in its final reasons paper and stated consumers should be provided with options and alternatives to enable them to make an informed choice on price quality trade-offs.

- 35 Regarding this, we believe it would be helpful if the IMs are more express regarding the extent of consultation required or and perhaps a better alternative may be (given prescription may not be useful for unknown events or circumstances) to enable a mechanism to test with the Commission (or verifier) whether what is proposed by an applicant is sufficient.
- 36 However, in our specific circumstances, even if consultation requirements are clearly stipulated, the timeframes we were working to (as set out in the **IMs**) would not allow us to calculate the impact of the multiple options on consumers and present multiple options to consumers including the impact of each option on the consumer, gather meaningful feedback and then revise our proposal. In fact, the timing of the WACC determination in September coupled with an obligation to begin consulting on the “effect” of the proposal in November seriously constrains the timeframe we had to consult on the proposal itself let alone options or alternatives.
- 37 In addition to our obligations to engage with consumers, we consider that the extent of Commission’s obligation to consult could be reviewed. We do not consider that the consultation via the Issues Paper which was undertaken prior to the draft determination was effective in enhancing an understanding of consumer needs.
- 38 Further we question whether the Commission is best placed to represent the proposal. For example, were actual price quality trade-offs adequately represented in the Commission’s consultation? In addition, is it necessary to repeat consultation on the proposal with consumers, pre and post application.

Proposal Content

- 39 The IMs are a very comprehensive and prescriptive set of rules setting out what and how information is to be provided. On the face of it there is benefit to this but in our circumstances, where the nature and extent of our catastrophic event was not fully contemplated by the IMs, it was, in some circumstances too rigid.
- 40 It was our experience that the IMs require the applicant to provide more information than is necessary to assess an application. Further some requirements are ambiguous and/or repetitive (for example Schedule D), and excessive (for example evidence to support related party transactions and alternative depreciation). Consequently, there is a risk that key messages from the applicant get lost in the volume of information that must be provided.

- 41 In addition, the IMs require material to be presented in a specific way that did not align with processes and information sources we hold. For example:
- The asset valuation and regulatory tax IMs which are components of the price path require a great deal of disaggregation of forecast data which creates model complexity and it is questionable whether this is necessary
 - Schedule E templates are very prescriptive with significant detail. Recasting our information into these templates was very onerous and, in the case of allocating projects and programmes to service categories, not meaningful.
- 42 This further compounds the resource intensive nature of preparing a proposal and did lead to internal frustration in our business when material was required to be “re -configured” into the prescribed format. It also compromised our ability to provide historical and forecast information on a consistent basis, because it is not always possible to reformat historical information to fully meet unanticipated reporting requirements. This was particularly difficult for us, as some of detail behind our historical financial data was unable to be recovered following the earthquakes.
- 43 Conversely, with respect to Schedule D, it was unclear what supporting information needed to be provided for each project or programme and whether it was useful. A possible alternative is to provide that information on request. Some of the supporting information was in our AMP and it was rewritten to comply with Schedule D requirements. We encourage the use of existing information sources where possible to reduce compliance steps.
- 44 We also note that a written proposal only gets you so far. In our process we had workshops and meetings with the Commission and these were very effective in enhancing understanding of our processes and procedures.
- 45 Broadly speaking, our view of the core information relevant to a CPP proposal is:
- Why the application is being made
 - An AMP, including sufficient project/programme information
 - Price path models, consistent with the IMs, plus project/programme spreadsheet schedules
 - A quality standard proposal (possibly including models)
 - Customer consultation (with scope perhaps previously set out and agreed between applicant and Commission).
- 46 As is the case currently, a broader application is also required which includes the proposal, perhaps verification (of quality too), audit and certification reports.

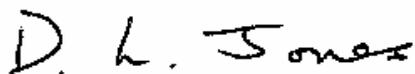
General Comments

- 47 Given our application was the first of its kind, there was a degree of interpretation required with respect to the IMs and in some instances, how the IMs would apply to us was not clear. We used our legal advisors at times to help interpret requirements in the IMs and the Act. During our proposal preparation we engaged frequently with the Commission team and most issues were worked through where possible with them. Understanding and interpretation will naturally improve as a body of precedents build up.
- 48 As noted above, some of the most productive sessions we had were the face to face meetings or workshops with Commission staff. They were an effective way to share information, test assumptions and understand our proposal.

Concluding remarks

- 49 Overall we question whether the CPP application process in its current form is suitable for a catastrophic event of the size that Christchurch experienced. The process requires considerable commitment of resource that could be better used elsewhere and it is extremely time consuming and resource intensive. As we set out in our feedback above we encourage the Commission to consider ways to simplify and/or reduce the amount of information that needs to be provided for a CPP (catastrophic or otherwise) and also the way it is provided.
- 50 Thank you for the opportunity to provide this feedback. Orion does not consider that any part of this paper is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager - Commercial), DDI 03 363 9526, email Dennis.Jones@oriongroup.co.nz.

Yours sincerely



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ATTACHMENT A

CPP application timeline

