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## **SUBMISSION ON INPUT METHODOLOGIES REVIEW TECHNICAL CONSULTATION**

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the Commerce Commission's (the **Commission**) consultation paper 'Input methodologies review Technical consultation update paper' (**Technical Paper**) released on 13 October 2016 and the accompanying technical draft of the new input methodologies (**IM**) determination for electricity distribution businesses (**EDBs**).
- 2 We have reviewed and support the submission by the Electricity Networks Association (the **ENA**) on the Technical Paper and supporting draft IM determination. We do not seek to replicate the ENA's detailed comments on the draft. This submission responds to those points within the Technical Paper and draft determination that are of most importance to Orion.
- 3 In particular, this submission comments on:
  - 3.1 The new proposals in the Technical Paper regarding the cost of capital
  - 3.2 The revenue cap and revenue cap wash-ups
  - 3.3 The implications of changes to live line work on the quality standard
  - 3.4 Other points of detail and Orion-specific matters.

### **Cost of capital**

#### ***Debt issuance costs***

- 4 The Technical Paper has put forward what is effectively a new draft decision regarding debt issuance costs. This is to remove the notional debt issuance costs allowance from the WACC (which is currently 0.35%). Instead the Commission will include an allowance for debt issuance costs in the building blocks allowance at each price reset.
- 5 As this value will be determined outside the IMs, only limited details are available about how it will be calculated – for example, it is not clear whether this allowance will be part of the opex allowance or a separate building block.

- 6 We are concerned that a fundamental change to the cost of capital methodology has been introduced at a late stage in the IM review process without clear supporting evidence. There is insufficient time for this proposal to be properly considered and evidence to be gathered.
- 7 The justification provided in the Technical Paper for this proposal seems to be that there is “a high degree of uncertainty over what the efficient level of debt issuance costs should be”.<sup>1</sup> This is not a strong enough reason for changing the IM approach, especially as the change is a deviation from the principle that the WACC should reflect the notional efficient cost of capital of an EDB rather than the actual cost of capital of each EDB. We note there is also uncertainty in relation to other WACC parameters but the Commission deals with these.
- 8 It is also not clear how this approach would be applied in practice – the Technical Paper does not describe how business-specific estimates would be derived. As debt issuance costs fluctuate over time based on market conditions and the nature of the debt being raised, setting an allowance that matches actual costs could be challenging. Without the Commission describing its proposed method submitters cannot have confidence that the opex allowance for debt issuance costs will be at the right level.
- 9 We support:
- 9.1 retaining the notional debt issuance cost allowance in the WACC.
  - 9.2 continuing to set the notional debt issuance cost allowance at 0.35% as no compelling evidence has been provided to justify a change in the IMs.

***Historical average method for debt premium***

- 10 The Technical Paper suggests a method for applying a ‘historical averaging’ approach to set the debt premium. This is to calculate a debt premium estimate each year based on three months of data in that year and then average 5 years of these estimates.
- 11 We are pleased the Commission is considering the implementation of a historical average approach. We think the Commission’s proposal is better than both the status quo and the proposal made in the June draft decisions consultation.
- 12 However, the Commission’s proposal is not a full five year average, but an average of samples taken in the same quarter of each of the five previous years. We do not believe this proposal is superior to a full five year average. We support using a full five year average as this will avoid any systematic issues that may arise from using the same quarter from each year.

**Revenue cap and revenue cap wash up mechanisms**

- 13 We support the revenue cap approach for EDBs. Our interest now is ensuring that the methodology for applying the revenue cap is cost effective and not overly complex.

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<sup>1</sup> Technical Paper, para 76.

- 14 We recognise the Commission has attempted to simplify and explain its method, by removing one of the wash-up mechanisms and by providing flow chart explanations of how the revenue cap compliance tests and wash-ups would work.
- 15 However, we still find the method to be very complex, which is elaborated on in the ENA submission. We support simplifying the method by making the following changes:
- 15.1 removing the ‘function of demand’ compliance test. It is not clear how the function of demand will be calculated or whether this will set an appropriate limit on price changes. There is also no evidence that any price smoothing limit is needed for a revenue cap.
- 15.2 simplifying clause 3.1.3, perhaps by moving all revenue cap requirements into a different clause.
- 15.3 clarifying how the transition from the current weighted average price cap plus pass-through balance to the revenue cap will occur (this should include carrying over the remaining pass-through balances at the end of the current regulatory period into the revenue cap wash-up account).
- 16 If these changes were made, the revenue cap method would be much less complex and would reflect a true revenue cap. The Commission would retain the ability to add further conditions to the cap to address problems if they arise in future.

#### **Cap on wash-ups following a catastrophic event**

- 17 The Commission now proposes that the cap on the wash-up amount, to prevent EDBs recovering their full losses following a catastrophic event, will be 20% of what is now called ‘forecast net allowable revenue’ (the equivalent of maximum allowable revenue). We remain of the view that such a cap is not justified. However, if this cap is to apply setting it at 20% of *total* revenues would be reasonable.
- 18 We note the Commission’s proposal is for the cap to be 20% of revenues net of pass-through and recoverable costs. We recommend the cap is specified as 20% of revenues including pass-through and recoverable costs (i.e. 20% of forecast allowable revenue). This is more reasonable than the Commission’s proposal because, under the Commission’s proposal:
- 18.1 EDBs will have to carry the cost of any lost pass-through and recoverable cost revenues following a catastrophic event; and
- 18.2 the extent of EDBs’ exposure to catastrophic events will therefore fluctuate depending on the size of pass-through and recoverable costs, which is outside of their control.

#### **Live line work and the quality standard**

- 19 We endorse the recent letter from the ENA to the Deputy Chairperson of the Commission regarding the impact of a reduction in live line work on the DPP quality standard.
- 20 The Health and Safety at Work Act 2015 is likely to lead to a change in how the industry approaches live line work with a corresponding increase in SAIDI and SAIFI. Our initial

estimates are that, in 2015, the changed approach to live line work would have had a material effect on our SAIDI and SAIFI.

- 21 We support:
- 21.1 removing the materiality threshold for change event reopeners that affect the quality standard, as a 1% of revenue materiality threshold is difficult to meaningfully apply to the quality standard.
  - 21.2 developing a methodology for assessing the cost and quality impacts of the increase in de-energised work and the reduction in live line work.
  - 21.3 the Commission, using data provided by Orion and other EDBs that are subject to price control, releasing a revised CPP determination for Orion and a revised DPP determination for other EDBs with adjusted quality standards.

### **Orion specific matters**

#### ***CPP asymmetric IRIS***

- 22 As the Commission is aware, Orion is subject to an asymmetric IRIS under our current CPP. We want to ensure that any carry over amounts from this IRIS are appropriately treated as recoverable costs from 1 April 2019. There are transitional provisions that seek to achieve this from clause 3.3.15 of the IMs.
- 23 Clause 3.3.16 provides that incremental changes and incremental adjustment terms must be “notionally carried forward” into each of the five subsequent disclosure years and provides that a “net balance” must be determined for each year following the end of the CPP regulatory period.
- 24 Clause 3.1.3(1)(a)(ii) provides that any positive net balance determined in accordance with 3.3.15(2) is a recoverable cost, subject to certain audit requirements being met. This appears to be an error – clause 3.1.3(1)(a)(ii) should instead refer to clause 3.3.16(2).

#### ***Amending a DPP during a regulatory period***

- 25 Orion is concerned that the Commission’s views on section 53ZB of the Act and the transitional provisions in clause 1.1.2 of the draft IM determination may mean this error cannot be corrected in time for the 2020 regulatory year.
- 26 Section 53ZB provides that, with some limited exceptions:
- “Default or customised price-quality paths may not be reopened within a regulatory period on the grounds of a change in an input methodology”*
- 27 Clause 1.1.2(4) of the draft IM determination provides that amendments to Part 3 of the IMs do not come into force until the start of the next DPP or CPP.
- 28 The Commission appears to have interpreted section 53ZB very broadly, to mean that no updated IM definitions or requirements can apply to a DPP until the next reset. We submit that this goes too far. If an IM amendment changes the definition of a pass-through or recoverable cost or corrects an error in those definitions (such as the error noted above), this is not a ‘reopening’ of a price path – it does not adjust the allowable

revenue or required quality standards – and thus should not be prevented from applying by means of section 53ZB.<sup>2</sup>

### **Other matters**

#### ***Transitional issues***

- 29 The transitional arrangements for implementing the draft IMs are complex. We appreciate the Commission has gone to some effort to clarify this but are concerned that readers of the IMs could be confused between what is and is not in force at any one time. IM readers will also need to regularly refer back to previous versions of the IMs which will add to the complexity and the risk of misinterpretation.
- 30 We suggest the Commission publish a version of the IMs containing all extant provisions only and then periodically update this version as new sections come into force. This would then give some confidence to readers that they were relying on the correct version of the IMs.

#### ***Urgent project allowance***

- 31 The Technical Paper clarifies that prudently incurred costs for urgent projects can be recovered through a CPP when the project occurs between the submission of a CPP application and the CPP's commencement date. This clarification is welcome.

#### ***Extended reserves***

- 32 The implementation requirements for this recoverable cost, as set out in clause 3.1.3(7)(a) seem incorrect. We support the comments of the ENA submission in this regard.

### **Concluding remarks**

- 33 Thank you for the opportunity to make this submission. We do 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](mailto:dennis.jones@oriongroup.co.nz).

Yours sincerely



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<sup>2</sup> It is not clear to us whether the error identified would meet the "error event" price path reopener.