15 April 2016

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SUBMISSION ON ORION'S TRANSITION TO THE 2015-2020 DEFAULT PRICE-QUALITY PATH – KEY CONSIDERATIONS AND POSSIBLE APPROACHES

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the Commerce Commission's (the **Commission**) consultation paper "Orion's transition to the 2015-2020 default price-quality path – Key considerations and possible approaches" (the **Paper**).

2 We also welcome the opportunity to engage with the Commission on how a DPP might be determined for us at the end of our CPP. This is critical to our consideration of whether to apply for another CPP or to transition back to the DPP.

3 The current DPP will only have one year to run at the end of our CPP. While it is important for us to consider the transition for that one year, when considering a further (5 year) CPP the most significant consideration for us is the 2020 DPP reset.

4 Accordingly, in this submission we address transitional considerations for the current and next DPP regulatory periods.

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Summary of views

5 In summary we submit:

5.1 we support the Paper's option 2 (roll over prices with no claw-back and a CPI adjustment) – because it will generate allowable revenues that meet the purpose of Part 4, it is superior to the other options in meeting this objective and it is a low cost method to implement

5.2 our decision on whether to apply for another CPP is dependent on gaining a better understanding of:

(a) the one year DPP;

(b) how our five-year 2020 DPP price-quality path might be set relative to the other controlled EDBs. We understand that the Commission can't yet define exactly how EDBs' five-year DPPs might be reset in 2020. However, we need to better understand whether/how the Commission might treat our five-year reset differently to those for the other non-exempt EDBs

5.3 that section 53X of the Act provides the Commission with some discretion in setting starting prices when transitioning from a CPP to a DPP

5.4 that sections 52A(1) and 53P of the Act are relevant to how starting prices are to be set under these circumstances

5.5 that the Input Methodologies (IMs) that were in effect when a DPP is set, are those that should apply when setting DPP starting prices at the end of a CPP (for a DPP that still has time to run before it expires)[1]

5.6 that the length of the DPP regulatory period is also of relevance to the starting price method, and for Orion, the one year DPP period suggests a low cost approach should be applied.

6 We look forward to discussing this with the Commission over the forthcoming months.

CPP or DPP

7 If we were to transition to another CPP we would need to submit the CPP application in early 2018, and thus commence preparation of it shortly.

[1] Unless the IMs were reset under s 53ZB(2)

8 CPP applications are costly and resource intensive. While the Commission's current IM review may simplify the CPP IM, the IM requirements will not be known until the end of this calendar year. In addition, given recent draft amendments published by the Commission[2], we expect they will still require substantial volumes of material to be prepared to support a CPP application.

9 We are therefore keen to explore whether a DPP could best meet the needs of our customers and other stakeholders at the end of our CPP. We consider this will be the most cost effective option for us, and importantly allow our business to focus on delivering our work programme and restoring our network capability. This decision requires gaining a better understanding of the DPPs which might apply to us once the CPP ends.

10 Currently the key areas of uncertainty are how starting prices will be set once the CPP ends for the one year remaining of the current DPP, and how the price path, including in particular opex forecast and capex forecast, and quality standards will be set at the end of the current DPP. The paper addresses the first point.

Section 53X of the Act

11 As stated in the paper, section 53X of the Act, provides the Commission with discretion in how DPP starting prices are set following a CPP. We agree with the paper which suggests that in exercising this discretion the Commission should be mindful of section 52A(1) which sets out the purpose of Part 4 regulation, and section 53K, which sets out the purpose of default/customised price-quality regulation.

12 We support the proposal outlined in the paper, that in assessing whether the purpose of Part 4 is met, the Commission will consider the efficiency, complexity and costs of the options. We support finding a solution which ensures the costs and complexity of the transition process are no greater than necessary. We agree that having just one year of the DPP remaining at the end of the CPP is of relevance to this consideration.

Section 53P of the Act

13 Section 53P sets out requirements for setting DPP starting prices. Section 53P sets out two options for setting starting prices:

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[2] Commerce Commission, Input Methodologies Review – Customised Price-Quality Paths, Overview of matters to be discussed at the workshop for electricity distribution businesses (and associated material), 30 March 2016

13.1 prices that applied at the end of the preceding regulatory period

13.2 prices based on current or projected profitability.

14 Section 53P also places some limits on how these prices are set, by excluding comparative benchmarking and recovery of excess profits from a prior regulatory period.

15 We agree that these provisions are relevant to the transitional method for setting starting prices for us, should we transition back to the DPP.

Setting starting prices

16 The paper puts forward three possible approaches to setting our starting prices for the last year of the DPP, as follows:

16.1 set starting prices to equal the allowable prices that apply at the end of our CPP

16.2 set starting prices to equal allowable prices that apply at the end of our CPP, after excluding claw-back and following a CPI adjustment

16.3 set starting prices based on building blocks analysis (ie: the approach used in setting the 2015-2020 DPP).

17 We have considered each of these options, and support the second option for the following reasons:

17.1 a roll over option is expected to be less costly to implement compared to a building block option, and therefore is well suited to a one year regulatory period

17.2 a roll over option better reflects our underlying costs because it incorporates our post-earthquake circumstances more effectively than a DPP building block option

17.3 the claw-back component of the final year CPP prices should not be reflected in DPP starting prices, as the claw-back allowance will have been fully recovered in the CPP regulatory period

17.4 a CPI adjustment should be applied to a roll over approach, as this is consistent with the DPP and CPP specification of prices as specified in the IMs, and provides an allowance for general inflationary pressure on costs

17.5 it is consistent with the purpose of Part 4 of the Commerce Act, as specified in section 52A(1), as demonstrated in the following paragraphs.

18 In order to test whether our preferred option is consistent with section 52A we have estimated the starting prices under each of the options proposed in the paper. We have compared these with our best estimate of our building block costs in 2020 derived using the CPP price path model[3], and populated with FY15 regulatory disclosure information, our most recent AMP forecasts, which were published on 31 March 2016, and the 2015-2020 DPP cost of capital.

19 The following table summarises these results.

Table 1: Indicative starting prices under options presented in the paper

Option	Commission's Possible Approaches	Source	DPP starting price estimate 2020 ($m)
1	Set starting prices the same allowable prices at end of CPP including clawback without CPI adjustment	FY19 MAR before tax (Commission's CPP model for Orion)	180.7
2	Set starting prices the same as allowable prices at end of CPP excluding clawback with CPI adjustment	FY19 MAR before tax (Commission's CPP model for Orion) without clawback and DPP CPI (price path) forecast	175.4
3	Apply starting prices different from allowable prices at end of CPP BBAR at end of current DPP price path model (set in Nov 2014)	FY20 BBAR before tax (Commission's 2015 to 2020 DPP model)	167.7
Cross check	Building block analysis(based on FY15 data and 1 April 2016 AMP forecasts)	FY20 BBAR (Commission's CPP model for Orion)	178.0

[3] For the avoidance of doubt, we are not supporting a detailed building block approach to setting starting prices, as would be required if the CPP model was used.

20 Option 1 is expected to generate revenues in excess of our forecast costs, which could be viewed as inconsistent with section 52A(1)(d) - the strand of the purpose statement which focuses on limiting excessive profits. At the same time, this option could be expected to provide sufficient incentives for us to invest in infrastructure to meet consumer demand for electricity lines services.

21 Option 3 is expected to generate revenues which are below our forecast costs, and while this would limit our ability to extract excess profits, it may also restrict our ability to invest in order to meet our consumers' needs. This is not surprising given the cost base does not reflect our post-earthquake investments. A building blocks analysis which is derived from base year information which occurred prior to the CPP coming into effect, but subsequent to the catastrophic earthquakes, cannot be an appropriate basis on which to set starting prices. It would also be inconsistent with the improved quality standards which are to apply to us in the final year of the DPP. The level of revenue that this option provides will compromise our ability to maintain quality standards which are already challenging to achieve, even with the considerable investment we are making during the CPP regulatory period.

22 Option 2 is also expected to generate revenues which are below our forecast costs – but by a lesser extent than option 3. This option therefore appears to be consistent with Section 52A(1)(d) in limiting our ability to extract excessive profits, while providing more incentive to invest (52A(1)(a)) and meet consumer demand for quality of service (52A(1)(b)) than Option 3. In addition, as the allowable revenue is less than our forecast costs, the price path will provide efficiency incentives which is consistent with 52A(1)(c). The simplicity of this option means that the cost and complexity objectives for the one year transition can also be met. We therefore consider that option 2 is consistent with section 52A(1) and better meets the purpose of Part 4 than the other options proposed.

23 We note that the paper does not include any information about how each of the options could be implemented in the DPP amendment determination. We would be happy to work with the Commission on the drafting of the determination, once a preferred option has been determined.

Setting the 2020 DPP price path

24 As noted above the paper does not consider how our 2020 DPP price path could be set, this is an important consideration for us in assessing whether a further CPP is required. We look forward to discussing this further with the Commission over the forthcoming months.

25 In the interim we suggest that a reasonable approach may be to apply exactly the same methodology as may be applied to other non-exempt EDBs as a first step, before assessing whether any business specific adjustments are required. This would appear to be consistent with the options set out in the IM emerging views on DPP/CPP processes.[4]

IMs that apply when an EDB returns to the DPP

26 We wish to clarify the commentary in paragraphs 25 to 27 of the paper on the IMs that will apply when the CPP ends. This is particularly relevant as the IMs are currently under review, with potential amendments scheduled to be completed by the end of calendar year 2016.

27 The current DPP was set in late 2014, and is consistent with the relevant IMs which applied at that date. Any amendments to the IMs will not apply to the DPP until it is reset at 1 April 2020. This conclusion is supported by paragraph 26 of the paper which states:

> *when returning to a DPP, an EDB will become subject to the DPP set previously which may have been set under earlier IMs. The DPP does not get updated or reset); an EDB becomes subject to the same DPP as all the other EDBs that are not subject to a CPP.*

28 The DPP Determination sets out the quality standards and some of the elements of the price path that would apply to Orion, should we transition back to the DPP at the end of the CPP.

29 The DPP Determination did not set the starting prices that would apply to Orion at that time and the Commission is intending to make further decisions in this respect following this current consultation. We understand that these are to be incorporated by way of an amendment to the Determination.

30 As discussed above there are a number of approaches which could be used to set starting prices, some of which could be influenced by IMs. In our view, the IMs which applied at the time the DPP Determination was made are those which are to apply for this purpose. This is consistent with the statement in paragraph 26 of the paper.

31 However, paragraph 27 of the paper appears to suggest a contrary view, as follows:

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[4] Commerce Commission, Input methodologies review, Emerging views on opportunities to improve the way default and customised price-quality paths work together, 29 February 2016

> *However, where we set a new starting price under section 53X of the Act, then the applicable IMs are those that are in force when the transition from a CPP to a DPP occurs, to the extent they are relevant to setting the starting price*

32 We understand that this was not the Commission's intent and that the IMs that will apply should we return to the DPP are the IMs that were in place at the time the 2015 DPP Determination was made.

33 We note that section 53X is silent on the IMs that apply when setting starting prices when transitioning from a CPP to a DPP.

34 We also note that paragraph 53 of the paper includes a proposed process for setting our DPP starting prices, with an indicative final decision date of October 2016. This is before the IM amendments will have been determined.

35 Further, we note that it is not clear how amended IMs could apply in practice to setting our starting prices under the DPP Determination. For example, if the cost of capital IM changes, the next DPP cost of capital determination that will be made (and thus align to amended IMs) will apply from 1 April 2020 – after the current regulatory period.

36 None of the starting price options proposed in the paper should be impacted by changes to the IMs which may be made since the 2015 DPP was determined. Accordingly, we submit that the IMs that will apply to the DPP at the end of our CPP, should we choose to transition to the DPP, are those that applied at the time the 2015 DPP was determined, including in respect of setting starting prices.

IRIS scheme

37 We also wish to clarify the commentary in paragraphs 36 to 41 of the Paper in regards to the Incremental Rolling Incentive Scheme (IRIS) that applies to us under the CPP, and once the CPP ends.

38 As the paper correctly states, our CPP includes an IRIS scheme. This is an asymmetric IRIS that applies only to opex. This was determined in accordance with the IMs which applied at the time the CPP was set. It requires us to treat the net balances of the scheme as recoverable costs which are recovered over a five year period, once the CPP regulatory period ends.

39 In 2014 the IMs were amended to change the IRIS scheme, and extend it to the DPP. This scheme applies to capex and opex, and is symmetrical. In the 2015 DPP Determination we were specifically carved out of this scheme up to the end of the current DPP regulatory period.

40 Accordingly, it is our understanding that:

40.1 If we move onto another CPP at the end of the current CPP, the CPP IRIS IMs which apply at that time will apply to us – unless a CPP variation is adopted

40.2 If we move to the DPP:

(a) For the last year of the current DPP regulatory period, the DPP IRIS will not apply

(b) The DPP IRIS IMs which apply for the next regulatory period, from 1 April 2020 will apply to us.

41 Notwithstanding the above, we will also be permitted to include IRIS incentive recoverable costs (calculated in accordance with Clauses 3.3.12 and 3.3.13 of the IMs) when setting prices in the five year period immediately following the end of the CPP, irrespective of whether we transition to the DPP, or a new CPP is determined.

42 We would be happy to discuss this interpretation further, if the Commission has an alternative view.

Quality

43 One of the key drivers for moving to a CPP was to set new quality standards which reflected the post-quake performance capability of our network. The CPP quality standards incorporate a gradual reduction in the SAIDI and SAIFI limits that apply to us during the CPP regulatory period.

44 To date our assessed values for SAIDI and SAIFI have tracked very closely to the CPP standards, reflecting a gradual improvement in the performance of our network as anticipated when the CPP quality standards were set.

45 The 2015 DPP Determination specifies the quality standards that will apply should we transition to the DPP at the end of the CPP. These will apply for one year – to the end of the DPP regulatory period – and have been set equal to the SAIDI and SAIFI limits which apply in the final CPP year.

46 The DPP Determination also includes a quality incentive mechanism which introduces financial incentives and penalties for non-exempt EDBs where assessed SAIDI and SAIFI performance departs from quality targets. The revenue at risk, used to determine the value of our financial incentives, have been set to zero for the 2020 assessment period.

47 Under the CPP and the 2015 DPP Determination, compliance with the quality standards is assessed on a two out of three year basis. It is our

understanding that the 2 out of 3 year assessment is intended to carry over between regulatory periods, and therefore our quality performance in the last two years of the CPP will be taken into consideration in the first year of the DPP, should we transition to a DPP at the end of the CPP.

48 Our decision as to whether or not to apply for another CPP will depend partly on the appropriate quality standards for our network from 2019 onwards. We are still undertaking the remedial work required to address the impact of the earthquakes and therefore we are not yet able to determine how our network may perform at that time.

49 In addition, it is not clear how our quality standards will be set following the current DPP period. To date DPP quality standards have been set with reference to historical quality performance. The 2012 DPP used a 5 year dataset, and the 2015 DPP used a 10 year dataset for each non-exempt EDB for this purpose. If a similar approach were to be used at the 2020 reset, it would capture historical quality performance for Orion which is influenced by the earthquakes.

50 As indicated above a reasonable approach may be to apply exactly the same methodology as may be applied to other non-exempt EDBs as a first step, before assessing whether any business specific adjustments are required. We suggest that specific consideration of our historical quality performance may be appropriate when the DPP is reset in 2020 – and importantly may provide a lower cost regulatory outcome than the CPP alternative. We note that in the recent Gas DPP consultation paper[5] the Commission has suggested that it may consider using more business specific information to set the DPP for each gas supplier than it has in the past.

51 We also note that the current IM review is considering whether there may be more options to re-open DPPs to address business specific circumstances.[6] While we support introducing mechanisms which make the DPP more flexible, we consider a re-opener is a relatively cumbersome way to set a DPP which is appropriate for us.

52 We look forward to engaging further with the Commission on how the 2020 DPP quality standards may be set for Orion, prior to making a decision as to whether to transition back to the DPP.

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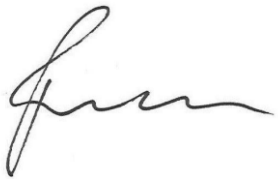
[5] Commerce Commission, Default price-quality paths for gas pipeline services from 1 October 2017, Process and issues paper, 29 February 2016

[6] Supra, n3

53 Concluding remarks

54 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.

Yours sincerely



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