2015-19 Customised price-quality path Orion New Zealand Limited – Consultation on proposed approach to the specification of controllable opex

30 October 2013

Purpose of this paper

1. This paper advises interested persons of our proposed approach to the specification of controllable operating expenditure (opex) within Orion New Zealand Limited's (Orion's) customised price-quality path (CPP) Controllable opex will be used under the incremental rolling incentive scheme (IRIS) to calculate incremental gains and losses to be carried over to the next regulatory period and treated as recoverable costs. [1]

2. This paper also:

   2.1 invites submissions on our proposed approach; and

   2.2 sets out details of technical consultation to be held on drafting changes to our draft determination to reflect this approach.

Process followed to date to set the customised price-quality path for Orion

3. On 14 August 2013, we published our draft decision reasons paper for Orion's 2015-19 CPP. We released our draft determination for setting this CPP on 4 September 2013.

4. We received submissions and cross-submissions on our draft decision reasons paper and draft determination in September and October 2013.

5. We have considered all submissions and cross-submissions and expect to publish a final determination and reasons paper on 29 November 2013.[2]

How you can provide your views

6. Submissions on the specific topic set out in this paper are due by **5pm Wednesday 13 November 2013**.

7. We currently anticipate issuing an updated draft determination for technical consultation on drafting changes for controllable opex on **Wednesday 6 November 2013**. Submissions on these drafting changes are also due by **5pm Wednesday 13 November 2013**.

[1] The IRIS currently specified under the IMs is asymmetric. This means that while both incremental gains and losses will be carried forward to the subsequent five years, only positive net balances in the next regulatory period of those amounts carried forward will be treated as recoverable costs.

[2] A list of materials received in consultation on our draft determination is available at http://www.comcom.govt.nz/regulated-industries/electricity/cpp/orion-cpp/.

8. Consultation on the update of our draft determination is limited to submissions on the technical drafting changes to the draft determination to reflect our proposed approach to specification of controllable opex. It is not an opportunity for submissions on the substantive content and approach to the updated draft determination. Any other drafting changes to be made to our draft determination as a result of submissions and cross-submissions will be made prior to the release of our final determination.

9. It will be helpful if, where an alternative for drafting changes included within our updated draft is proposed, submissions provide specific technical drafting suggestions that give effect to that alternative.

10. Our update of the draft determination reflects our analysis of submissions relevant to controllable opex. Our response to all other submissions and cross-submissions received to date will be provided in our final determination and discussed in our final reasons paper.

11. We will not be seeking cross-submissions on any submissions received.

12. Please address submissions to:

    Keston Ruxton, Chief Adviser, Regulation Branch
    c/o regulation.branch@comcom.govt.nz

13. Submissions should be provided in both MS Word and PDF formats.

Requests for confidentiality

14. While we discourage requests for non-disclosure of submissions, we recognise that there may be cases where parties that make submissions wish to provide information in confidence. We therefore offer the following guidance:

    14.1 We intend to publish all submissions on our website.

    14.2 If it is necessary to include confidential material in a submission, the information should be clearly marked.

    14.3 We ask you to provide multiple versions of your submission if it contains confidential information or if you wish the published electronic copies to be locked.

    14.4 Both confidential and public versions of the submission containing confidential material should be provided.

    14.5 Both an unlocked electronic version of your submission and a clearly labelled public locked version should be provided if you wish the published version to be locked.

14.6 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

Specification of controllable opex within Orion's customised price-quality path

Orion's proposal

15. Orion chose not to include any opex as controllable opex for the purpose of its CPP proposal. Orion explained in its proposal that this is on the basis that "we believe it is more important for our customers that we 'get the job done' over the next five to seven years, rather than strive for some potentially 'arbitrary' efficiency gains."[3]

Our draft decision

16. Under clause 5.3.1(a) of the Electricity Distribution Services Input Methodologies Determination (the IMs),[4] the Commission is required to set 'controllable opex' for Orion's 2015-19 CPP regulatory period.

17. In our draft decision reasons paper, we sought the views of interested parties on whether we should:

    17.1 determine an asymmetric IRIS for Orion, consistent with the IMs;

    17.2 vary the IMs so that we can determine a symmetric IRIS for Orion; or

    17.3 vary the IMs so that we do not need to determine an IRIS for Orion, consistent with its CPP Proposal.[5]

Submissions on our draft decision

18. In its submission and cross-submission on our draft decision reasons paper, Orion stated that it believed its initial rationale for not electing to include any opex as controllable opex for the purposes of its CPP proposal remained valid. Orion challenged any implication that excluding controllable opex from its proposal was inconsistent with the IMs or that the IMs required that a "positive amount must be included for controllable opex."[6] Orion reaffirmed this view in its cross-submission, where it stated that "[w]hile we understand the incentive objectives of an IRIS, our CPP proposal and submission explained why we did not feel able to nominate components of our planned opex as controllable opex as required for the CPP IRIS."[7] In its cross-submission, Orion also raised questions about how controllable opex would be identified, how this would relate to opex reductions proposed by the

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3 Orion "Proposal for a customised price-quality path" (19 February 2013), pp.570-1.

4 Commerce Commission, *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26.

5 Commerce Commission "Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited – Draft decision" (14 August 2013), paragraph 4.21.

6 Orion "Orion CPP proposal: Draft Decision" (20 September 2013), p.84.

7 Orion "Orion CPP Proposal Draft Decision: Cross submission" (11 October 2013), p. 33.

Commission in its draft decision and why potential efficiencies should be allocated to consumers immediately.

19. Powerco submitted that “given the IRIS is asymmetric, it only offers an upside benefit for Orion. As the CPP will naturally provide incentives for Orion to become more efficient as it is ex ante, having nil controllable opex is actually more beneficial for consumers. Given this fact, we consider that Orion’s approach is consistent with the Part 4 purpose statement”[8]

20. Electricity Networks Association (ENA), and Orion submitted that “an approach more consistent with the purpose statement would be to set Orion’s prices at a level sufficient to ensure Orion has incentives to invest (i.e. that it is able to recover its prudent costs), and that any benefits from efficiency gains are shared with consumers ex post once they have been achieved (e.g. through the DPP reset process or subsequent CPPs).”[9] These submitters considered that “an incremental rolling incentive scheme (or IRIS) is another mechanism the Commission has available to it to share with consumers the benefits of efficiency gains.”

21. Finally, Vector also submitted that “[i]f it is possible to develop a robust forecast of controllable opex, Vector sees no reason for the Commission not to determine an IRIS that is consistent with the IMs.”[10]

Our updated draft determination

22. Consistent with the IMs, we propose to specify within the update of our draft determination that controllable opex is equal to our draft allowances for forecast opex for each disclosure year of the 2015-19 CPP regulatory period.

Reasons for our updated draft determination

23. Having considered submissions and cross-submissions received, we propose to do this for the reasons set out below.

24. As set out in our IMs final reasons paper for electricity distribution and gas pipeline businesses, although ex ante price-quality path regulation promotes efficiency improvements, the way in which such price-quality paths operate can create perverse incentives regarding the time at which efficiency gains are made. IRIS schemes specifically address the shortcomings of the within-period model by allowing suppliers to retain the benefits of any efficiency gains for a fixed number of years, irrespective of when they occurred within the regulatory period. [11]

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8 Powerco “Powerco submission to Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited: Draft Decision” (20 September 2013), p.6.

9 Electricity Networks Association “Comment on Commissions Paper on Orion’s CPP Application” (24 May 2013), p.4, also quoted at Orion “Orion CPP Proposal Draft Decision: Cross submission” (11 October 2013), p. 32.

10 Vector Limited “Submission to the Commerce Commission on Orion CPP Draft Decision” (20 September 2013), p.26.

11 Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper” (22 December 2010), paragraphs 8.5.1-8.5.5.

25. In doing so, IRIS schemes promote the Part 4 purpose by providing suppliers with equalised incentives to pursue efficiency gains throughout the regulatory period and promoting certainty for suppliers and consumers as to how efficiency gains by suppliers will be treated.

26. Orion stated in its proposal that "we believe it is more important for our customers that we 'get the job done' over the next five to seven years, rather than strive for some potentially 'arbitrary' efficiency gains."[12] However, in order to meet the requirements of clause 5.3.1(a), the Commission needs to set a baseline for the amount of allowed controllable opex and indicate which of the regulated supplier's opex categories are included within this allowed controllable opex baseline and used to compare actual controllable opex with this baseline on a like-for-like basis. Leaving these unspecified effectively turns IRIS off for the purpose of Orion's CPP.

27. Powerco also stated that "the Commission has not detailed why it considers that Orion's proposal for $0 controllable opex does not meet the IMs".[13] We do not consider that this approach would comply with the IMs, because controllable opex must be an allowance which is reasonable in light of the expenditure objective.[14]

28. We therefore propose to set controllable opex in by determining that all categories of Orion's forecast opex as controllable and setting controllable opex equal to our allowances for forecast opex for each disclosure year of the CPP regulatory period.

29. For the most part, we consider that forecast opex is a forecast of controllable opex within the CPP regulatory period. This is because it excludes the two categories of costs the Commission has decided allow suppliers to pass through to customers due to the fact that they are not fully controllable by suppliers – pass-through costs and recoverable costs. Pass-through costs are those costs that are outside the control of the supplier and can be passed through to consumers without the Commission needing to undertake any assessment of the costs.[15] The main difference between pass-through and recoverable costs is that recoverable costs are not completely outside the control of the supplier and there may be judgement involved as to how much should be passed through.[16]

30. We consider that this approach is consistent with the Australian Energy Regulator's (AER's) approach to calculating actual and forecast opex under its Energy Benefit Sharing Scheme (EBSS). Under this scheme, amounts of actual and forecast opex

12 Orion "Proposal for a customised price-quality path" (19 February 2013), pp.570-1.

13 Powerco "Powerco submission to Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited: Draft Decision" (20 September 2013), p.6.

14 Commerce Commission "Electricity Distribution Services Input Methodologies Determination 2012" *[2012]* NZCC 26, clause 1.1.4.

15 Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" (22 December 2010), paragraphs 8.3.25.

16 Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper" (22 December 2010), paragraphs 8.3.27.

used for the purposes of calculating any carryover amounts are based on total opex less specified exclusions for uncontrollable amounts.[17]

31. Defining controllable opex as including all opex categories other than those specifically excluded also limits the difficulty involved in identifying suitable categories of opex to be included.

32. Although, as submitted by Powerco, the IRIS will be asymmetric and "only offers an upside benefit for Orion, having $0 of controllable opex is actually more beneficial to consumers.",[18]We think that on balance IRIS will strengthen incentives sufficiently to ensure that consumers are better off and that improvements in incentives for suppliers to pursue efficiency savings throughout the regulatory period will benefit consumers in the long term. The long term impact of incentives under the IRIS is therefore likely to outweigh the impact of any transfers away in the short term since these transfers away are a product of IRIS's mechanism for sharing benefits between suppliers and consumers over time.[19]

33. As part of our assessment of Orion's CPP proposal, the Commission will determine allowances for opex. The allowances that we determine will be those we consider to meet the expenditure objective. They will therefore reflect our best view of the needs of Orion's network and the long term interests of consumers.

34. All incremental efficiencies generated by Orion over and above this level of expenditure will be shared by Orion and consumers under the IRIS. The incentive-based rewards under IRIS will be the incremental gains and losses calculated by comparing actual opex in the CPP regulatory period with the Commission's allowance for forecast opex. The IRIS will then allow Orion to retain any efficiency gains for five years before these are shared with consumers.

Topics to consider

35. In light of these considerations, we want to hear your views on how we propose to determine controllable opex for the purposes of Orion's CPP. We therefore invite submissions on any of the matters discussed above.

[17] Australian Energy Regulator "Electricity distribution network service provider – Energy benefit sharing scheme" (June 2008), pps. 6-7.

[18] Powerco "Powerco submission to Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited: Draft Decision" (20 September 2013), p.6.

[19] Orion will also continue to be subject to information disclosure requirements for actual opex for each disclosure year. In the event that the input methodologies are amended to provide for a changed IRIS, this may apply to Orion from the date of the amendment subject to the outcome of the process and any required consultation, which would be undertaken by the Commission prior to doing this.