



## Orion's transition to the 2015-2020 default price-quality path – Key considerations and possible approaches – 14 March 2016

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### Purpose

1. This paper invites interested parties to comment on our key considerations and possible approaches for managing Orion New Zealand Limited's (Orion) transition from its customised price-quality path (CPP) to a default price-quality path (DPP).

### Orion's CPP and the DPP applying to 16 electricity distributors

2. On 29 November 2013, we determined a CPP to apply to Orion between 1 April 2014 and 31 March 2019.<sup>1</sup>
3. On 28 November 2014, we set the DPP applying to 16 electricity distribution businesses (EDBs) for the five-year period from 1 April 2015 to 31 March 2020 (2015-2020 DPP). The 2015-2020 DPP specified a rate of change and quality standards for Orion, but did not determine the starting prices for Orion.<sup>2</sup>
4. Unless Orion seeks another CPP, it will transition from its CPP to the 2015-2020 DPP on 1 April 2019. This means that Orion will only be subject to the 2015-2020 DPP for one year.
5. We are commencing this work now so that Orion can make an informed decision about whether to apply for another CPP. This timeline might not be appropriate in different circumstances.

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<sup>1</sup> *Orion New Zealand Limited Customised Price-Quality Path Determination 2013* [2013] NZCC 21, 28 November 2013.

<sup>2</sup> For more detail on the treatment of Orion in the 2015-2020 DPP refer to: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020: Main policy paper" 28 November 2014, Attachment A.

*Structure of this paper*

6. In this paper, we explain:
  - 6.1 our decisions and consultation on Orion's treatment when setting the 2015-2020 DPP;
  - 6.2 the key considerations for our approach if Orion decides to transition to the 2015-2020 DPP; and
  - 6.3 possible approaches for setting Orion's starting prices if it transitions to the 2015-2020 DPP.
7. We have already specified the rate of change and quality standards to apply to Orion if it decides to transition to the 2015-2020 DPP.<sup>3</sup> This paper focuses on our proposed approach to setting Orion's starting prices.
8. We would like to know your views on the key considerations and possible approaches if Orion transitions to the 2015-2020 DPP. Details on how to make submissions and cross-submissions can be found at paragraph 55.

**Decisions and consultation on Orion's treatment when setting the 2015-2020 DPP**

9. In March 2014 we set our preliminary views as to how we would treat Orion under the reset of the 2015-2020 DPP.<sup>4</sup> We advised the interested parties that possible options regarding the starting prices were:
  - 9.1 the price that applied in the final year of the Orion CPP; or
  - 9.2 a price advised by us before the end of the Orion CPP.
10. We also consulted on the quality standards applicable to Orion at the end of its CPP.

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<sup>3</sup> When its CPP ends, Orion will have the productivity-based rate of change that is generally applicable to distributors (CPI + 0%) and be subject to the quality standards (the SAIDI and SAIFI reliability limits of 73.4 and 0.87 respectively) that we determined on 28 November 2014, which will only apply between 1 April 2019 and 31 March 2020. Refer: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020: Main policy paper" 28 November 2014, paragraphs A11-A18.

<sup>4</sup> Commerce Commission "Default price-quality paths from 1 April 2015 for 17 electricity distributors: Process and issues paper" 21 March 2014, paragraph D21.

11. We received submissions from the Electricity Networks Association (ENA) and Orion. The ENA considered that Orion was best placed to respond to our proposals.<sup>5</sup> Orion agreed with our proposed approaches to determining starting prices, rates of change and quality standards when the Orion CPP ends. Specifically, Orion agreed that we did not need to determine its starting prices at that time.<sup>6</sup>
12. In July 2014, we shared our further thinking on the starting price that applies to Orion when the Orion CPP comes to an end.<sup>7</sup> Our final decision in November 2014 was to:
  - 12.1 not determine the starting prices for Orion at that time; and
  - 12.2 specify a rate of change and quality standards to apply to Orion for when the Orion CPP ends.
13. We also determined that Orion would be subject to the same revenue-linked incentive scheme for quality as other distributors when its CPP ends, but with the target, cap, and collar set equal to its reliability limits, and 0% revenue at risk.<sup>8</sup>

**Key considerations for our approach if Orion decides to transition to the 2015-2020 DPP**

14. The key considerations for our approach if Orion decides to transition to the 2015-2020 DPP are:
  - 14.1 our interpretation of section 53X of the Act;
  - 14.2 our interpretation of section 53P of the Act in the context of this process;
  - 14.3 input methodologies (IMs) that apply when an EDB returns to the DPP;
  - 14.4 our current thinking about whether the IMs should include a price-quality path transition process; and
  - 14.5 how incentive amounts for the Incremental Rolling Incentive Scheme (IRIS) are calculated.

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<sup>5</sup> ENA "Submission on proposed default price-quality paths for electricity distributors from 1 April 2015" 15 August 2014, paragraph 171.

<sup>6</sup> Orion New Zealand Limited "Submission on the proposed DPP for EDB's from 1 April 2015" 15 August 2014, paragraph 21.

<sup>7</sup> Commerce Commission "Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015" 4 July 2014, Attachment A.

<sup>8</sup> Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020 Main policy paper" 28 November 2014, Attachment A.

*Our interpretation of section 53X of the Act*

15. Section 53X of the Act provides us with discretion in setting starting prices in a way that best meets the purposes of Part 4 of the Act and the specific type of regulation at issue.
16. Section 53X of the Act provides that upon expiration of a CPP:
 

... (2) The starting prices that apply at the beginning of the default price-quality path are those that applied at the end of the customised price-quality path unless, at least four months before the end of the customised price-quality path, the Commission advises the supplier that different starting prices must apply.
17. Our current view is that we have discretion in setting starting prices under section 53X of the Act. In exercising our judgement we must do so in the manner that best meets the purposes set out in sections 52A and 53K of the Act.<sup>9 10</sup> However, we consider that the section 52A purpose provides the primary objectives and considerations that we must give weight to when exercising our judgement.
18. The price-quality path regime we set must operate in such a way as to promote outcomes that are consistent with the outcomes produced in workably competitive markets, such that the objectives in section 52A(1)(a) to (d) of the Act are met. In this context, a relevant consideration is the length of the DPP regulatory period still to run when an EDB transitions from a CPP (ie, one year in Orion’s circumstances).
19. We should take into account the efficiency, complexity and costs (for the regime as a whole and for EDBs in particular) in deciding how to approach our task under section 53X of the Act. The price-quality path regime should work as effectively as possible so that the costs and complexity of the process for coming off a CPP onto a DPP are no greater than necessary.

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<sup>9</sup> Section 52A(1) of the Act sets out the purpose of Part 4 of the Act: “The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services— (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and (d) are limited in their ability to extract excessive profits.

<sup>10</sup> Section 53K of the Act sets out the purpose of default/customised price-quality regulation: “the purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances”.

20. It may not be appropriate for the transition back to a DPP to accommodate all of an EDB's specific circumstances. The transition from a CPP to a DPP under section 53X of the Act reflects a move from the individually tailored approach of a CPP to a more generic, relatively low-cost, DPP.

*Our interpretation of section 53P in the context of this process*

21. Our current view is that section 53P of the Act is a relevant consideration for our decision-making process regarding Orion's transition to the 2015-2020 DPP.
22. Section 53P of the Act sets out the process requirements for the resetting of starting prices of a DPP in terms of consultation, and prescribes certain limits on our approach.
23. Under section 53P of the Act, starting prices:
- 23.1 are either the prices that applied at the end of the preceding regulatory period or based on the current and projected profitability of each EDB;
  - 23.2 must not seek to recover excess profits from the prior period; and
  - 23.3 are not derived from comparative benchmarking.
24. Our current view is that it is appropriate for us to apply the section 53P restrictions on setting starting prices when making decisions under section 53X of the Act. This is unless particular circumstances lead us to consider that this would be inconsistent with section 52A or section 53K of the Act.

*IMs that apply when an EDB returns to the DPP*

25. In general terms, the IMs that apply to an EDB are the current IMs.<sup>11</sup>
26. 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.
27. 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. There is nothing in section 53X of the Act that suggests that the general requirement in section 52S of the Act is not applicable to such a decision.

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<sup>11</sup> Section 52S of the Act. The Commission is reviewing the current IMs and this is expected to be completed by December 2016.

*Current thinking on whether to include a price-quality path transition process in the IMs*

28. We do not plan to include in the IMs for CPPs any prescriptive process for the transition from CPPs to DPPs. We think that the long-term benefit of consumers would be best served by providing clarity about our process outside of the IMs, enabling consideration of an EDB's particular circumstances at the time.
29. In February 2015, we published an open letter with our proposed scope, timing and focus for the review of the IMs.<sup>12</sup> In June 2015, we published a further paper seeking interested parties' input in identifying the key topics and defining the specific problems to be addressed by our review of the IMs.<sup>13</sup> We received submissions in August 2015, and a number of submissions requested us to consider developing an IM to cover the transition from CPPs to DPPs.<sup>14</sup>
30. Orion has submitted that we should:<sup>15</sup>
- ...include, in the CPP IMs, the generic process the Commission will take for the transition of other EDBs subject to CPPs back onto DPPs...
- This process should include the consultation steps that will be taken and when they will occur. The CPP IMs should also include the factors the Commission will take into account when deciding whether to roll over the prices that apply at the end of the CPP or to reset the prices".
31. Similarly, the ENA has submitted that:<sup>16</sup>
- The IMs could usefully specify the circumstances in which the prices that apply on moving back to a DPP will be those that applied at the end of the CPP, and the circumstances where the Commission would advise that different prices would apply...
- ...the IMs could also usefully set out the process (although not necessarily the methodology) the Commission must follow for making decisions regarding the prices that will apply following a CPP".
32. The price-quality path regime represents a balance between certainty for EDBs and consumers, and flexibility for us to exercise our regulatory judgement in adjusting the regulatory controls from time to time to keep them fit for purpose.

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<sup>12</sup> Commerce Commission "Open letter on our proposed scope, timing and focus for the review of input methodologies" 27 February 2015.

<sup>13</sup> Commerce Commission "Input methodologies review: Invitation to contribute to problem definition" 16 June 2015.

<sup>14</sup> Orion New Zealand Limited "Submission on the IM Review" 21 August 2015, paragraphs 35-37; PwC "Submission to the Commerce Commission on Input methodologies review: invitation to contribute to problem definition made on behalf of 20 Electricity Distribution Businesses" 21 August 2015, paragraphs 123-124; Electricity Networks Association "Response to the Commerce Commission's Input Methodologies review paper" 21 August 2015, paragraphs 122-124.

<sup>15</sup> Orion New Zealand Limited "Submission on the IM Review" 21 August 2015, paragraph 37.

<sup>16</sup> Electricity Networks Association "Response to the Commerce Commission's Input Methodologies review paper" 21 August 2015, paragraph 124.

33. The legislation is not prescriptive on the process for transition of an EDB from the CPP to the DPP, and the relevant considerations might vary on a case-by-case basis. Certainty under Part 4 is provided primarily through the IMs and through fixing a price-quality path for a set regulatory period. Flexibility is recognised in the section 53P DPP reset process, and in the CPP process.
34. Given the particular circumstances, we considered that it was desirable to start this consultation process 36 months before Orion's CPP ends. However, a similar timeline may not necessarily be appropriate in the future for Orion or other EDBs that may transition from a CPP to a DPP.
35. We rely on EDBs subject to a CPP to engage with us about when to begin consultation on their transition to a DPP so that they can make an informed decision about whether to apply for another CPP.

*Calculation of incentive amounts for the Incremental Rolling Incentive Scheme*

36. Orion's CPP contains specific rules for the calculation of incentive amounts for the IRIS.<sup>17</sup> These provisions were not affected by the November 2015 amendments to the IMs.<sup>18</sup>
37. The IRIS provides a mechanism by which EDBs that are subject to price-quality regulation can retain the benefits of efficiency gains beyond the end of a regulatory period.
38. The IMs establish that the IRIS incentive adjustment for EDBs (including Orion's future price-quality paths) is the amount determined in accordance with the formula:<sup>19</sup>

opex incentive amount + capex incentive amount

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<sup>17</sup> *Orion New Zealand Limited Customised Price-Quality Path Determination 2013* [2013] NZCC 21, 28 November 2013, clause 12.

<sup>18</sup> Commerce Commission "Further amendments to input methodologies for electricity distributors subject to price-quality regulation Incremental Rolling Incentive Scheme (IRIS)" 25 November 2015, paragraph 5.3 and footnote 61.

<sup>19</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, as amended, clause 3.3.1(2).

39. However, the IMs also establish that Orion does not need to calculate an opex or capex incentive amount for any year commencing *on or prior to* 1 April 2020.<sup>20</sup> Therefore, Orion will not calculate an incentive for 2019 if it transitions to the 2015-2020 DPP.<sup>21</sup>
40. Furthermore, the IMs set out that Orion does not need to calculate an amount carried forward for any disclosure year commencing prior to 1 April 2019. However, if Orion starts a new CPP in 2019, then it will be required to calculate amounts carried forward. These amounts then become an opex incentive recoverable cost in the regulatory period commencing after that new CPP expires.<sup>22</sup>
41. In summary:
- 41.1 If Orion transitions to the 2015-2020 DPP in 2019 and subsequently onto the 2020-2025 DPP, it will start calculating amounts carried forward from the first year of the 2020-2025 DPP, which will become a recoverable cost in the following regulatory period (ie, 2025-2030).
- 41.2 If Orion starts a new CPP in 2019, it will start calculating amounts carried forward immediately (ie, in the first year of that new CPP), which will become a recoverable cost following expiration of that new CPP.

### **Possible approaches for setting Orion's starting prices**

42. Possible approaches for setting Orion's starting prices include:
- 42.1 setting starting prices the same as the allowable prices that apply at the end of Orion's CPP (these prices include provision for claw-back);
- 42.2 setting starting prices the same as the allowable prices that apply at the end of Orion's CPP (excluding claw-back), with a CPI adjustment; or
- 42.3 applying starting prices different from the allowable prices that apply at the end of Orion's CPP, based on 'building blocks' analysis (ie, the approach used for setting the 2015-2020 DPP).
43. These options are not an exhaustive list and we are open to considering alternatives. We welcome submissions on how these or any other options may meet the key considerations set out in this paper for managing Orion's transition to the 2015-2020 DPP.

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<sup>20</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, as amended, clauses 3.3.2(3)(a) and 3.3.10(3)(a).

<sup>21</sup> Orion will still notionally calculate an amount carried forward in 2019, but that amount is nil. *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, as amended, clause 3.3.3(5).

<sup>22</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, as amended, clause 3.3.3(6)(a).



*How we will consider which particular approach may be appropriate*

44. Setting starting prices the same as the allowable prices that apply at the end of Orion's CPP is not our preferred approach, in particular because these prices include provision for claw-back.<sup>23</sup>
45. Unlike a DPP, where claw-back is a recoverable cost over and above the price path, Orion's price path under its CPP includes claw-back amounts. We think that it is likely appropriate to remove claw-back from Orion's price path before a CPI adjustment is applied. This is because the annual claw-back amounts were calculated to be completely recovered over the five years of the CPP period.
46. We are open to considering the option of setting starting prices the same as the allowable prices that apply at the end of Orion's CPP (excluding claw-back), with a CPI adjustment. A CPI adjustment could be calculated in accordance with schedule 3B of the 2015-2020 DPP determination and schedule 1B of Orion's CPP determination.<sup>24</sup>
47. Our decision will depend on the extent to which evidence provided by Orion convinces us that a particular approach is consistent with s 52A. In terms of making a decision that meets the objectives in section 52A(1)(a) to (d), there is always a natural tension between providing suppliers with incentives to invest and limiting their ability to extract excessive profits.<sup>25</sup>
48. The option of setting starting prices the same as the allowable prices that apply at the end of Orion's CPP (excluding claw-back), with a CPI adjustment would be consistent with section 53K and section 53P of the Act because it would be:
- 48.1 a relatively low-cost way of managing Orion's transition to the final year of the 2015-2020 DPP; and
- 48.2 based on Orion's current and projected profitability.<sup>26</sup>

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<sup>23</sup> In determining Orion's CPP, we decided that Orion should be allowed to claw-back \$34.8m of additional net costs incurred due to the Canterbury earthquakes over the five year CPP period. Refer: Commerce Commission "Setting the customised price-quality path for Orion New Zealand Limited: Final reasons paper" 29 November 2013, Attachment B.

<sup>24</sup> *Electricity Distribution Services Default Price-Quality Path Determination 2015* [2014] NZCC 33, schedule 3B; *Orion New Zealand Limited Customised Price-Quality Path Determination 2013* [2013] NZCC 21, 28 November 2013, schedule 1B.

<sup>25</sup> Commerce Commission "Input Methodologies (Electricity Distribution and Gas Pipeline Services): Reasons Paper" 22 December 2010, paragraph 2.4.7.

<sup>26</sup> The allowable prices that apply at the end of Orion's CPP were set using a 'building blocks' approach to assessing its current and projected profitability for the 2014-2019 period. Using these allowable prices as the basis for setting Orion's starting prices for the 2015-2020 period would therefore be consistent with section 53P(3)(b).

49. We are also considering the option of applying starting prices different from the allowable prices that apply at the end of Orion's CPP, based on 'building blocks' analysis (ie, the approach used for setting the 2015-2020 DPP). However, given that Orion would be subject to the 2015-2020 DPP for only one year, a 'building blocks' approach to setting its starting prices may be an unnecessarily costly exercise, particularly if a simple CPI adjustment would yield a similar result.
50. In circumstances where an EDB transitions from a CPP to a DPP earlier in a regulatory period, using a 'building blocks' approach to set starting prices may better promote the section 52A and section 53K purpose statements.

*We need further information before deciding on an approach*

51. We invite Orion to provide evidence, such as expected costs, to explain why its preferred approach for setting starting prices for the one year remaining on the 2015-2020 DPP would be consistent with s 52A. Before we decide on an approach for Orion's transition, we would need to be satisfied that, for example, Orion would:
- 51.1 be limited in its ability to extract excessive profits during this time; and
- 51.2 continue to have sufficient incentives to innovate and invest.
52. We also welcome views from other interested parties on the possible options, including feedback on any implementation and compliance implications, and our proposed process.

**Proposed process**

53. Table 1 provides an indication of our proposed process for making a decision on our approach for setting Orion's starting prices if it transitions to the 2015-2020 DPP.

**Table 1: Proposed process**

<b>Process step</b>	<b>Date</b>
Submissions on this paper	8 April 2016
Cross-submissions on this paper	22 April 2016
Draft decision	June 2016 <sup>27</sup>
Final decision	October 2016 <sup>28</sup>

54. We will update interested parties on any changes to our proposed process following consultation on this paper.

<sup>27</sup> This date is an indicative date only.

<sup>28</sup> This date is an indicative date only.

**How you can provide your views**

55. We invite you to provide your written submissions on this paper within the following timeframes:

55.1 Submissions are due by **5pm, Friday 8 April 2016.**

55.2 Cross-submissions are due by **5pm, Friday 22 April 2016.**

*Address for submissions*

56. Submissions on this paper, labelled with the topic ‘Submission on Orion’s transition to 2015-2020 DPP – Key considerations and possible approaches’, should be addressed to:

Matthew Lewer

Manager, Price-Quality Regulation, Regulation Branch

c/o [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

*Format for submissions*

57. Please provide your submissions in MS Word format.

*Requests for confidentiality*

58. We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner. However, if it is necessary to include confidential material in a submission, we offer the following guidance:<sup>29</sup>
- 58.1 Both confidential and public versions of the submission should be provided; and
- 58.2 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.
59. We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions and cross-submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

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<sup>29</sup> You can also request that we make orders under s 100 of the Act in respect of information that should not be made public. Any request for a s 100 order must be made when the relevant information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on s 100 orders if requested by parties. A benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. Any s 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.