15 August 2014

Regulation Branch
Commerce Commission
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SUBMISSION ON THE PROPOSED DPP FOR EDB'S FROM 1 APRIL 2015

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to provide a submission on the Commerce Commission's (**Commission**) proposed default price-quality paths for electricity distributors from 1 April 2015 (the paper) issued by the Commission in July 2014.

2 The Electricity Networks Association has also submitted on the paper. Orion endorses the ENA submission and recommendations.

Orion specific issues

Reconsideration of DPP following catastrophic events

3 We support extending re-opener provisions in the IMs to allow for a DPP to be re-considered following a catastrophic event.

4 We consider that, after a catastrophic event, suppliers should be compensated for:

4.1 prudent additional net costs incurred prior to resetting the DPP price path;

4.2 prudent additional net costs forecast to be incurred after the reset, to the end of the current regulatory period;

4.3 demand effects expected over the remainder of the DPP regulatory period; and

4.4 contrary to the Commission's proposal, we considers that demand effects that occur between the date of the event and the price path reset should also be

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compensated for, including demand effects that may lead to under-recovery of pass-through and recoverable costs, which the Commission allowed in Orion's CPP.

5 In addition a re-opener should allow for a sensible reset of the pre-event quality limits.

6 Below, we discuss both the extension of the re-opener provision and what should be considered or included as part of that.

Extending the IMs to re-open a DPP after a catastrophic event

7 Orion is currently operating under a customised price path (CPP).

8 As is well documented in our CPP application, the Canterbury earthquakes significantly impacted our ability to meet our quality standards and placed significant costs on us. These costs were not reflected in our network prices because our regulated price cap was determined prior to the earthquakes.

9 There was no regulatory mechanism that could deal with the impact of those quakes in a timely way. Following an attempt to achieve a faster and simpler resolution via an order in council under the CERA legislation, ultimately our only option, was a lengthy and costly CPP process. Certainly, a CPP could not be entertained in the year after the February 2011 earthquake given the extent of damage and the thousands of aftershocks.

10 We applied for a CPP which came into effect on 1 April 2014, over 3 years after the February 2011 quake.

11 Given this, there is an immediate need for an alternative option to applying for a CPP. In light of our experience on this issue, we now consider that a much simpler and more timely mechanism is required than was available to Orion. We consider that our experience following a catastrophic event puts us in a unique position of being able to support the introduction of a re-opener for a DPP, following a catastrophic event. That re-opener should provide immediate relief to an EDB incurring significant cost and address an inability to comply with quality standards going forward.

Content of a re-opener

12 As indicated above we consider that, after a catastrophic event, both the price and quality dimensions of the pre-event DPP should be reset.

13 As previously submitted, we consider that the regulatory response to a catastrophic event should consider all of the risks faced by suppliers, including demand risk, prior to a price path reset.

14 We do not agree with the Commission's arguments on allocation of risk and we are disappointed that the Commission is persisting with its argument that revenue risk

best sits with an EDB given its owner's ability to diversify. It is wrong to rely on a theoretical diversification standard as we have previously indicated[1].

15 As our expert Incenta noted[2] in the course of the CPP process, diversification by investors cannot reduce the effects of asymmetric events. Diversification is a technique that enables investors to reduce the risk premium required to invest in a particular asset. It cannot reduce the cost of physically running a business (that is, operating, maintaining and investing in an asset). It follows that the ability for investors to diversify cannot reduce the cost associated with uncertain events any more than it can reduce operating and maintenance costs.

16 And in any case, boards of EDBs must make investment decisions on their own merit, not on the basis of their shareholders' investment strategies – a WACC that is too low because of an inappropriate regulatory approach will disincentivise investment – and underinvestment is not in the long term interests of consumers. A regulatory WACC that is lower than EDBs' own estimates of WACC will mean that more proposed projects will have estimated negative NPVs and so won't be approved. WACC is an opinion, not a fact and the risks of underinvestment are asymmetric over the long term for consumers.

17 We will comment in more detail on the issue of investor diversification in our submission on the IM WACC Draft Decision.

Starting prices

18 Orion has previously sought clarification regarding the process the Commission proposes to use to determine what prices and quality targets apply to us at the end of our CPP period. This relates to the last year of the next DPP period – FY 20.

19 Section 53X(2) of the Commerce Act sets out that the starting prices that will apply at the beginning of the DPP (from 1 April 2019) are:

19.1 those that applied at the end of the CPP; unless

19.2 the Commission advises that different starting prices must apply.

20 In its draft decision, the Commission states that, based on its interpretation of s 53X(2), it does not need to determine starting prices under this 2015 DPP reset.

21 Orion agrees with this interpretation of s 53X(2) and that the Commission does not need to determine starting prices for Orion now.

22 The Commission in its draft decision indicated that, if it were to set starting prices for Orion based on current and future profitability, its current view is that they would:

1 Orion submission "Orion CPP proposal: Commerce Commission's Draft Decision" September 2013
2 Jeff Balchin, Incenta Economic Consulting, ' Response to Professor Yarrow Advice on Orion CPP Determination', 27 June 2013

Apply input methodologies for WACC, which currently require us to apply the same WACC for all distributors under a default price-quality path;

Apply a forecast of inflation for revaluations that is consistent with the timing of the WACC determination;

Rely on up-to-date forecasts of operating and capital expenditure that take into account efficiency gains achieved under the customised price-quality path.

23 Subject to paragraph 26 below, we agree that it is appropriate that the WACC applying to the next DPP period should apply to Orion for the year 1 April 2019 to 31 March 2020.

24 We are unsure what the phrase "*Apply a forecast of inflation for revaluations that is consistent with the timing of the WACC determination.*" means in the context of our return to the DPP in 2019. If prices are rolled over, the RAB does not matter and if not then we consider that the Commission should use the most up-to-date information available.

25 Subject to paragraph 26 below, we agree with the Commission that it should rely on up-to-date forecasts of opex and capex. To this end we consider that the Commission should also rely on the most up-to–date FY2019 RAB and up-to-date opex and capex forecasts.

26 However we are cognisant of the fact that these prices are only being set for one year, before the general DPP reset occurs, and we request that the Commission balances the need for detailed forecasts with the costs of providing additional information beyond normal information disclosure requirements. The Act provides for a roll-over of existing prices. We submit that this should be considered by the Commission as a valid option.

Orion's view on process when CPP comes to an end

27 At this stage, the process to be used for our transition back to a DPP at the end of the CPP period remains uncertain and the reset of the DPP a year later adds further uncertainty.

28 In our submission on the Process and Issues Paper[3] we recommended that the Commission start consultation with Orion on the transition back to the default price-quality path at least 24 months before the end of our CPP, and we note the Commission proposes to start consultation with Orion on transition back to the default price-quality path at least 24 months before the end of our CPP, i.e by 31 March 2017.

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3 Orion Submission on the Default price quality path from 1 April 2015 for 17 distributors – process and Issues paper 30 April 2014

29 The Commission notes that the proposed timing is important because:

> *Orion New Zealand seeks to be able to make an informed decision on whether to move onto the default price-quality path or apply for another customised price-quality path;*
>
> *Orion New Zealand is unable to propose a customised price-quality path in the 12 months before the default price-quality path is due to be reset; and*
>
> *If Orion decides to apply for another customised price-quality path, statutory timeframes apply for our assessment and evaluation of the proposal (40 working days for a completeness assessment and 150 working days for an evaluation).*

30 We agree with the Commission on the timing issues and the need to have sufficient information to make an informed decision on whether to move onto the default price-quality path or apply for another customised price-quality path.

31 However, for the reasons outlined below we submit that an earlier start to the consultation process is needed.

32 We submit that, as a general principle, and to provide certainty, all EDBs need to know the process that the Commission will follow in setting starting prices and be able to calculate the starting prices as early as possible.

33 In the time since the Commission released its Process and Issues Paper we have reflected on the timeframes required should we wish to seek a further CPP. Also the Commission's draft DPP determination indicates that there will be two 'one week' windows in February and May in which EDB's may submit a CPP proposal.

34 In the event that Orion did decide to apply for a further CPP at the end of our current CPP period, the Commission would need to produce a final determination by November 2018, to apply from 1 April 2019. This, in turn, would require Orion to submit our proposal in either the May 2017 or February 2018 windows.

35 From our experience with our current CPP, a February window provides a very tight timeframe for all parties. We therefore consider that, should we decide to apply for a further CPP, submitting a proposal in May 2017 would be more appropriate. Accordingly, allowing 12 months to prepare the proposal, consult with customers, arrange verification and audit and so on would mean we would have to commence work on a further CPP proposal by May 2016.

36 In light of this, and to allow us time to consider what option to take, we now consider that we would need to understand the process and parameters the Commission will use for our transition back to a DPP and the process the Commission will use to set starting prices by January 2016.

37 In addition, as our price-quality path would be reset again the following year we also need to know and the process for the FY21 DPP reset.

Proposed rate of change

38 The Commission has indicated that when Orion's CPP comes to an end the productivity based rate of change (X-factor) that is generally applicable to distributors will apply to Orion. We agree with this approach.

39 ***Reliance on up to date forecasts***

40 The Commission has indicated[4] that its current view is that, if it resets our prices based on current and future profitability for FY2020, it will rely on up-to-date forecasts of opex and capex.

41 As indicated above we are comfortable with this approach in principle should the Commission's preferred option be to reset our prices based on current and future profitability for FY2020 rather than rolling-over our prices. However we are concerned that this may impose unnecessary costs on Orion if the Commission relies on s 53ZD or s 98 notices to obtain this additional information and requires audit and other sign off.

42 A further concern to Orion is understanding how the Commission will arrive at forecasts of Orion's capex and opex for the next DPP period (FY2021/25). Orion will be coming off an unprecedented period of both relatively high expenditure and uncertainty. Whatever has happened over the CPP period isn't likely to be a reliable guide for the following period.

Quality – Orion's CPP

43 The Commission has proposed that Orion will become subject to quality standards that the Commission determines before 30 November 2014 and that these quality standards will only apply between 1 April 2019 and 31 March 2020.

44 The Commission proposes to[5]:

44.1 *set Orion's SAIDI and SAIFI reliability targets equal to the SAIDI and SAIFI reliability limits for the last year of the customised price-quality path, ie, the 2018/19 year;*

44.2 *set the caps and collars for the SAIDI and SAIFI incentive mechanisms equal to the respective reliability target. This implies an incentive rate and revenue at risk of zero; and*

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4 Paragraph A9 Commerce Commission "Proposed Default Price-Quality Paths For Electricity Distributors From 1 April 2015" 4 July 2014

5 Paragraph 2.25 Commerce Commission " Proposed Quality Targets and Incentives for Default Price-Quality Paths From 1 April 2015" 18 July 2014

44.3 *retain the normalisation methodology, including the SAIDI and SAIFI boundary values, as applied during the customised price-quality path perio*d.

45 We agree with the Commission that these adjustments are necessary to reflect Orion's unique situation due to the substantial programme of work involved in the recovery.

46 We would like clarification regarding how the proposed approach is measured and monitored. Currently there is a "2 out of 3" year allowance regarding what constitutes a breach of the quality standards, but it is unclear how this rule would be applied for the one year DPP.

47 In addition, the Commission is clearly much more advanced in its thinking on quality than it is on starting prices. Orion submits that the Commission needs to be careful when delinking quality targets from expenditure allowances as the two are obviously inter-related.

Quality – current DPP consultation

48 For the avoidance of doubt our views above do not mean that we agree with the Commission's proposed formulation of the quality targets in its current DPP consultation round, including the significant departure from an international standard (IEEE). Orion has considerable concerns in this respect. We will respond in further detail on this issue in our submission on the Commission's proposed quality targets and incentives for default price-quality paths from 1 April 2015.

49 As a general observation we consider that the proposed scheme could be enhanced by retaining the 2 out of 3 assessment approach in addition to the financial penalty incurred under the Cap. Rather than the Commission considering taking further action where an EDB exceeds the cap in any one year, we recommend that the Commission applies the 2 out of 3 assessment approach before considering taking any further enforcement action.

Incremental Rolling Incentive Scheme

50 Orion rejects the Commission's proposals to change the asymmetric IRIS scheme applicable to opex, that Orion is subject to under its CPP, to a symmetric IRIS scheme applicable to both capex and opex.

51 We submit that the new IRIS scheme (amended IM) should only apply to Orion from the end of the CPP period so that only forecasts made and expenditure incurred from 1 April 2019 would be considered in the new IRIS scheme.

52 While there are currently no IMs for an IRIS scheme applicable to a DPP, there are IMs that provide for an asymmetric IRIS scheme relating to controllable opex that applies to a CPP. This seems acceptable where a CPP is being applied for in the normal course of events, rather than as a result of a catastrophic event, as forecasting is made in a "business as usual" environment. As the Commission is aware, in our

CPP application, we considered the option of an IRIS scheme and whether to nominate any opex as controllable opex for the purpose of the scheme. Given the numerous uncertainties which faced us (including the rebuild, future earthquakes, cost escalation, changing demand) we did not believe it was appropriate to include this mechanism in our CPP proposal.

53 We remain of this view. An IRIS scheme is not suitable for a CPP following a catastrophic event. We are not currently operating in a business-as-usual state. Our consumers and other stakeholders, such as CERA and developers, are also not yet living or working in a stable environment. This could make our forecasting less accurate.

54 The Commission imposed an asymmetric IRIS scheme for opex as part of our CPP. It did not impose an IRIS for capex.

55 The Commission, is now, within 6 months of our CPP taking effect, proposing to apply new IMs that provide for a symmetric IRIS scheme to both opex and capex incurred during the CPP period.

56 We disagree with the Commission's proposed approach. It is not reasonable to place significant reliance on forecasts produced in such a volatile and uncertain environment. Our rationale is the same as we set out in our CPP application and summarised above.

57 We will comment further on this issue in our submission on the IRIS IMs and the IRIS consultation paper.

General Issues

Productivity analysis

58 While we accept that the legislation requires that the Commission develop an X factor based on total factor productivity analysis (TFP). We are very concerned with the TFP analysis that the Commission has adopted and it's underlying database.

59 The issues with the unsuitability of the underlying dataset have been raised many times by many EDBs and their experts over the last decade or more. For example the report prepared on behalf of Orion by NERA in October 2003 "*Unacceptable electricity distribution productivity measures for resetting the price path threshold*" notes in relation to the then 'B' factor which represents the familiar overall industry-wide growth in Total Factor Productivity (TFP)

> *"Inherent to Dr. Lawrence's B factor calculations are two general problems and a specific problem with calculations that overstate his results:*
>
> - *First, he is limited to a New Zealand data set that is insufficient, in both quantity and quality, for the completion of a reliable index number TFP study.*

Dr. Lawrence makes no exaggerated claim about the suitability for TFP analysis of the Disclosure Data he uses (on the contrary, he often notes faults in his data). Yet he uses that data set anyway, with little more than a recommendation to "round down" as a remedy for those faults.

- *Second, recognizing the poor quality of his data, he makes a limited attempt to check his results for electricity distribution TFP against those obtained in jurisdictions with more and better quality data, such as the US. Studies in the US show much more modest TFP growth for a wide array of electricity distribution utilities over a long time period.*

- *Third, notwithstanding the poor data he has to work with, his calculations themselves substantially overstate the B factor, as I show."*

60 This data set has been in question for a considerable length of time and to such an extent that the use of comparative benchmarking based on this data was expressly prohibited in the Act. Indeed, as noted in section 3 of the Economic Insights report prepared for the Commerce Commission[6], Dr Lawrence again re-iterates a number of problems with the dataset.

61 In addition, we note that in the econometric study completed on behalf of the Commission in relation the modelling of opex forecast uses data from 2010 to 2013 *as these are years for which there is reliable information on network and non-network expenditure*. Dr Lawrence uses data from 1996 which is of questionable quality and does not contain *reliable information on network and non-network expenditure.* This raises the question as to whether it is fit for purpose.

Concluding remarks

62 Thank you for the opportunity to make this submission. Orion does not consider that any part of this cross submission 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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[6] Economic insights "Electricity Distribution Productivity Analysis:1996-2013" 24 June 2014