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## **Companion Paper on the Draft Determination and Compliance Requirements for Orion New Zealand Limited's 2014-2019 Customised Price-Quality Path**

Date: 3 September 2013

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## 1. Introduction

- 1.1 We have issued our draft decisions on the customised price-quality path for Orion New Zealand Limited (Orion). Our decisions will be given effect by way of an amendment to Orion's current default price-quality path determination.<sup>1</sup>
- 1.2 This companion paper provides an overview of the draft determination on Orion's customised price-quality path we propose to issue to give effect to our decisions on Orion's customised price-quality path (Draft Determination). In particular, it outlines the draft price-quality path compliance requirements that are set out in the Draft Determination.<sup>2</sup>
- 1.3 For consistency across our distribution services price-quality path determinations, we have endeavoured to align the text of the Draft Determination as much as possible with the form of the EDB DPP Reset Determination and the Gas DPP Determination.<sup>3</sup> The bulk of the Draft Determination should therefore be familiar to EDBs and GPBs without further explanation.
- 1.4 In addition to the terms unique to the customised price-quality path determination, we have made some minor changes to provide additional clarity.

### **We seek your views before we finalise our decision on the Draft Determination**

- 1.5 Accompanying this paper is our proposed Draft Determination for Orion, which we are releasing for technical consultation. Before we issue our final decision in the form of a final determination, we seek your input on whether the proposed Draft Determination accurately captures the Commission's decisions and Orion's obligations once the customised price-quality path is finalised.
- 1.6 The final Draft Determination will reflect our final decisions on the appropriate price-quality path for Orion. Consequently, some terms and provisions in the draft determination may need to change.

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<sup>1</sup> The *Electricity Distribution Services Default Price-Quality Path Determination 2010* (Commerce Commission Decision 685, 30 November 2009).

<sup>2</sup> Refer: Commerce Commission, Draft Reasons Paper: *Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited*, 14 August 2013, and Commerce Commission, Draft Determination: *Orion New Zealand Customised Price-Quality Path Determination 2013 [2013] NZCC XX*, 30 August 2013.

<sup>3</sup> Refer: Commerce Commission, *Electricity Distribution Services Default Price-Quality Path Determination 2012 [2012] NZCC 35*, 30 November 2012 (EDB DPP Reset Determination), and Commerce Commission, *Gas Distribution Services Default Price-Quality Path Determination 2013 [2013] NZCC 4*, 28 February 2013 (Gas DPP Determination).

- 1.7 Submissions on the Draft Determination are due along with submissions on our draft decision, by 5pm on 20 September 2013. Due to the tight timeframes for this project, this deadline will be strictly enforced and we are very unlikely to grant any extension.
- 1.8 Please email your submission to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz). And show 'Orion CPP draft determination' in the subject line of your email. All submissions will be published on our website.

**Table 1.1: Summary of next steps**

Process step	Date
Draft decision on Orion's customised price-quality path released	14 August 2013
Draft determination and paper on compliance released	3 September 2013
Submissions due on draft decision and draft determination	20 September 2013
Cross-submissions due on matters raised in submissions	11 October 2013
Final decision on Orion's customised price-quality path set in the final determination	29 November 2013
Orion's customised price-quality path begins	1 April 2014

## 2. Contents of the draft customised price-quality path determination

### Overview of the Draft Determination

- 2.1 By 29 November 2013, we aim to determine a customised price-quality path for Orion as a supplier of electricity lines services.

#### *Form of determination*

- 2.2 In accordance with s 53V(3) of the Act, the Commission's decision on the customised price-quality path must be given effect by way of amendment to the s52P DPP determination currently applying to the CPP applicant (ie, Orion). The process for amending a s 52P determination is set out in s 52Q.
- 2.3 Orion is currently subject to the *Electricity Distribution Services Default Price-Quality Path Determination 2010* (Commerce Commission Decision 685, 30 November 2009). The necessary amendment to that determination is captured in clause 3.1 of the Draft Determination.
- 2.4 As with our other DPP determinations, the Orion Draft Determination will include:
- 2.4.1 the price-path that applies, including the starting prices (in the form of maximum allowable revenues) and the rate of change;
  - 2.4.2 the quality standards that apply;
  - 2.4.3 the length of the regulatory period;
  - 2.4.4 the effective date of the determination;
  - 2.4.5 the annual compliance requirements; and
  - 2.4.6 how to determine pass-through costs and recoverable costs.
- 2.5 The Draft Determination will specify a maximum weighted average price constraint, as well as minimum standards for service quality, which is the same approach adopted in the EDB DPP Reset Determination. The path will remain in force for Orion for the regulatory period we set in our final decision (in our draft decision we have proposed a regulatory period of 1 April 2014 to 31 March 2019).

- 2.6 In our draft decision, we provided an explanation for each component of the customised price-quality path.<sup>4</sup> When we issue our final decision, Orion will be subject to a limit on its maximum weighted average prices (a ‘price cap’) and will be subject to steadily improving reliability limits over the regulatory period.

*Applicable input methodologies*

- 2.7 The Draft Determination must specify the input methodologies that apply, in accordance with s52P(3) of the Act. The input methodologies that apply to Orion are set out in clause 6 of the Draft Determination.

*Special recoverable costs treatment for unrecovered transmission charges incurred prior to the regulatory period*

- 2.8 The Commission must specify the amounts that may be recovered by an EDB as recoverable costs.<sup>5</sup> These recoverable costs are set out in Schedule 2 of our Draft Determination.
- 2.9 As explained in Chapter 5 of the draft decision, the Commission has proposed that Orion may only recover recoverable costs on an “as incurred” basis. This means that Orion may not pass-through recoverable costs relating to the period prior to the regulatory period. However we have made a draft decision that Orion may recover Transpower transmission charges for 2011 and 2012 that were not included as recoverable costs at that time.<sup>6</sup> The ability to recover these shortfall amounts is subject to a limitation that is intended to prevent Orion effectively recovering any of the amounts more than once.

*Special recoverable costs treatment for avoided transmission charges*

- 2.10 As explained in Attachment J of the Draft Reasons Paper, the Commission has proposed an allowance in setting the price path for the forecast purchase of spur assets from Transpower, subject to a reduction in the avoided transmission charges

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<sup>4</sup> Commerce Commission, Draft Reasons Paper: *Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited*, 14 August 2013, Chapter 5. The Draft Determination sets out the starting prices, and applicable rate of change, derived from the annual allowable revenues in accordance with the specification of price input methodology, as set out in clause 3.1.1 of the EDB IM Determination.

<sup>5</sup> The *Electricity Distribution Services Default Price-Quality Path Determination 2010* (Commerce Commission Decision 685, 30 November 2009), clause 3.1.3(3).

<sup>6</sup> Paragraph 5.73 of the Draft Reasons Paper.

that Orion would normally include as recoverable costs (in order to avoid any double-recovery).<sup>7</sup>

## **Annual compliance statement**

### *Due dates and assessment periods*

2.11 For each annual assessment period ending 31 March, Orion will be required to provide us with an annual compliance statement that demonstrates whether it has complied with the customised price-quality path.

### *Dates that compliance statements are due*

2.12 The two key dates in the reporting schedule are:

2.12.1 the date that Orion must submit its annual compliance statement to the Commission (50 working days from the end of each assessment period); and

2.12.2 the date that Orion must publish its compliance statement on its website (a further five working days after submission to the Commission).

### *Assessment periods align to Orion's pricing years*

2.13 We have aligned the assessment periods to Orion's pricing years, which run from 1 April to 31 March each year. Because they are aligned, all references in the Draft Determination are to the assessment periods.

### *Summary of reporting requirements*

2.14 The annual compliance statement will cover the following matters:

2.14.1 Compliance with the price path and reasons for any non-compliance;

2.14.2 Compliance with the quality standards and reasons for any non-compliance;

2.14.3 Director and Auditor certification of the compliance statement;

2.14.4 Details of any restructuring of Orion's prices during the assessment period

2.14.5 Details of large transactions during the assessment period;<sup>8</sup>

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<sup>7</sup> Under clause 3.1.3 of the DPP/CPPI input methodologies, Orion can pass-through transmission charges payable to Transpower or, if it purchases spur assets that would allow Orion to bypass (or avoid) those charges, to continue to recover the avoided transmission charges through the remainder of the regulatory period. (clause 3.1.3(e)). This provides an incentive for Orion to purchase spur assets where this will improve efficiencies (ie, promoting limb (b) of the purpose statement under s 52A of the Act), the benefits of which are subsequently passed on to consumers. (ie, promoting limb (c) of the purpose statement).



2.14.6 Details of pass-through costs and recoverable costs, including the calculations and recovery of avoided transmission charges; and

2.14.7 Details of indirect transmission charges, including Director certification of those calculations.

*Certification requirements*

2.15 Each compliance statement will be required to be accompanied by a Directors' certificate (signed by at least one Director of Orion), and by an independent audit report.<sup>9</sup>

2.16 Where Orion seeks to recover indirect transmission charges from consumers, the compliance statement must also include a statement signed by at least one Director that the charges accurately reflect the transmission services supplied to Orion.<sup>10</sup>

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<sup>8</sup> See Attachment A.

<sup>9</sup> These are required by clauses 10.2(c) and (d) of the Draft Determination. The required formats of the certificate and report are set out in schedules 4 and 5 of the Draft Determination.

<sup>10</sup> Clause 10.3(i) of the Draft Determination.

### 3. Explanation of the customised price path compliance requirements

#### Compliance with the price cap

- 3.1 In each assessment period, Orion must set its prices so that it does not exceed its price cap. Compliance with this constraint is assessed over each entire assessment period, rather than at any time during the period. Orion is not required to adjust its prices within an assessment period, but it may do so. Additional compliance information in such circumstances is necessary to assess whether Orion has complied with its price path.

#### *Compliance with the price path is demonstrated using notional values*

- 3.2 To assess compliance with the price cap in an assessment period, we compare the amount of revenue that Orion has generated through its pricing with the maximum amount of before-tax revenue that Orion is permitted to generate under the price path.
- 3.3 Rather than assessing Orion's actual revenue, we assess compliance on the basis of 'notional revenue'. The revenue is 'notional' because it is based on quantities that are lagged by two years, rather than the quantities for the year in question. This will ensure that all the values can be calculated at the time that Orion sets its prices.<sup>11</sup>
- 3.4 Two types of notional revenue figures will be calculated:
- 3.4.1 'Allowable notional revenue', which is the amount that Orion's prices are allowed to generate on a notional basis;<sup>12</sup> and
  - 3.4.2 'Notional revenue', which is the amount that the Orion's prices actually generate on a notional basis.<sup>13</sup>
- 3.5 The difference between notional revenue and allowable notional revenue will reflect Orion's pricing decisions. This is because equivalent quantity terms will be used in both expressions. If Orion prices appropriately, then notional revenue will be less than or equal to allowable notional revenue (see Box 3.1).

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<sup>11</sup> Clause 7.5 of the Draft Determination.

<sup>12</sup> See Attachment B.

<sup>13</sup> See Attachment C.

### Box 3.1: Price path compliance formula

Notional revenue must not exceed allowable notional revenue. The compliance formula expresses this as:

$$\frac{NR_t}{ANR_t} \leq 1$$

Where:

$NR_t$  is the notional revenue for the pricing year ending in year  $t$ ; eg, for the assessment period ending in March 2015,  $t = 2015$ .

$ANR_t$  is the allowable notional revenue for the assessment year ending in year  $t$ ; eg, for the assessment period ending in March 2015,  $t = 2015$ .

- 3.6 If Orion's prices change during the assessment period, then allowable notional revenue will be calculated using the weighted average prices that applied to the corresponding lagged quantities during the pricing year, ie, rather than the closing price.

*Orion will not be penalised for pricing below its price cap*

- 3.7 If Orion prices below its price cap in any year, the price allowed in subsequent years will not be reduced.<sup>14</sup> We have included a revenue differential term in the calculation of allowable notional revenue for the second and subsequent assessment periods to ensure that allowable notional revenue for any assessment period will not be affected by the prices Orion has set in the previous assessment period.<sup>15</sup>
- 3.8 There will be no revenue differential term for the first assessment year (2015). This is because the price cap applies from the start of the regulatory period onwards.
- 3.9 The revenue differential term will not allow Orion to recoup any under-recovery in a previous year. So while Orion will not be penalised for pricing below its allowable price, it cannot subsequently attempt to undo those actions by pricing above the cap in later years.<sup>16</sup>

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<sup>14</sup> Clause 3.1.1(1)(e) of the DPP/CPP input methodologies.

<sup>15</sup> Schedule 1B, paragraph 1, of the Draft Determination: refer to the adjustment term  $ANR_{t-1} - NR_{t-1}$ .

<sup>16</sup> See illustrated example in Attachment D.

### *Calculation of changes in the CPI*

- 3.10 The rate of change we allowed for Orion in our draft decision is CPI-0%. This means that allowable notional revenue will increase in line with inflation each year, where inflation is measured using changes in the Consumer Price Index (CPI).<sup>17</sup>
- 3.11 The allowed adjustment will be calculated using the eight most recent quarterly CPI values that are available prior to each pricing year (ie, 'lagged' CPI is used for measuring compliance with the price path).

### *Treatment of price restructuring*

- 3.12 Orion may restructure or change its prices during an assessment period. Given the potential implications of price restructures for compliance, the compliance statement is an appropriate vehicle to highlight price restructure information.
- 3.13 A restructure or change in prices will affect how notional revenue is calculated for that assessment period. Notional revenue is calculated using prices for the assessment period, and corresponding quantities from an earlier year. In most cases, it should be possible to trace the historical quantity information to a restructured price. In such circumstances, demonstrating compliance should be relatively straightforward.
- 3.14 However, in some cases historical quantity information corresponding to a restructured price may not exist. In this instance, Orion will need to estimate a quantity at the time it restructures its prices in order to ensure it will not breach its price path. If that quantity estimate is too low, Orion will set a price that is higher than it would be for those services if the estimate was accurate.
- 3.15 We consequently will monitor price restructures where estimates are used. Orion will be required to produce information concerning a restructured price for the compliance statement:<sup>18</sup>
- 3.15.1 The methodology used to determine the quantity estimate that is used to calculate notional revenue.
- 3.15.2 A forecast of the quantity for the assessment period in which the restructure occurs. This forecast must be prepared by Orion before the restructured price takes effect.

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<sup>17</sup> Schedule 1B of the Draft Determination.

<sup>18</sup> Clause 7.7 of the Draft Determination.

- 3.15.3 The actual quantity for the assessment period that corresponds to the restructured price.
- 3.15.4 An explanation of the reasons for any differences between the actual and forecasted quantity.
- 3.16 Quantity information for the period in which the price restructure occurs is not used to calculate notional revenue. This information is important, though, for ensuring that Orion takes care in making an estimate and to allow us to assess whether its estimate and forecast assumptions are reasonable.
- 3.17 As allowable notional revenue is determined using prices and quantities from prior years (prices from the previous assessment period, and quantities from the assessment period 2 years prior to the current assessment period), it will not be possible for a price restructure to increase allowable notional revenue in the current assessment period. Allowable notional revenue will be calculated using the weighted average prices that applied to the corresponding lagged quantities during the assessment period, ie, rather than the closing price.<sup>19</sup>

#### **Pass-through costs and recoverable costs**

- 3.18 Some costs that Orion faces may be passed through directly to its consumers (ie, not specified in the maximum allowable revenue under the Draft determination). These costs are defined as pass-through costs and recoverable costs in the input methodologies.
- 3.19 In addition to the classes of pass-through costs and recoverable costs that an EDB may recover under the EDB DPP Determination, Orion will be able to recover the following costs as recoverable costs in respect of Orion's CPP proposal:<sup>20</sup>
- 3.19.1 The fee payable to the independent verifier of the proposal;
- 3.19.2 The fee payable to the auditor of the proposal;
- 3.19.3 The fee payable to the engineer who reviewed Orion's proposed quality standard variation in the proposal;

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<sup>19</sup> This is given effect by clause 7.6 of the Draft Determination that requires that allowable notional revenue does not change as a result of a restructuring of prices.

<sup>20</sup> Clause 3.1.3 of the DPP/ CPP input methodologies.

3.19.4 The application fee payable to the Commerce Commission for the proposal;  
and

3.19.5 The fee payable to the Commerce Commission for assessing the proposal and making the customised price-quality path determination.

3.20 When demonstrating compliance, Orion will deduct pass-through costs and recoverable costs from its total regulated revenues.

*When pass-through and recoverable costs can be deducted*

3.21 Our draft determination specifies how Orion must calculate the amount of pass-through and recoverable costs that may be recovered in an assessment period.<sup>21</sup>

3.22 Orion can only deduct amounts of pass-through and recoverable costs that can be determined with a sufficient degree of certainty at the start of the assessment period. This is to minimise the chances of Orion over- or under-recovering its revenue.

3.23 In addition, the amounts of the pass-through costs or recoverable costs that are used to calculate notional revenues and allowable notional revenues must:

3.23.1 not have already been recovered by Orion, and not be able to be otherwise recovered from consumers or other parties (ie, these amounts must not be recovered twice by Orion); and

3.23.2 not relate to amounts that were incurred by Orion prior to the CPP period, with exceptions only for amounts of fees relating to the CPP proposal and for amounts of unrecovered pass-through costs relating to Transpower transmission charges for 2011 and 2012.<sup>22</sup>

3.24 Within the building blocks allowable revenue used to set Orion's price path are amounts that effectively duplicate recoverable costs in respect of transmission charges or avoided transmission charges in those categories of recoverable costs. These need to be adjusted each assessment period to avoid duplication of recovery

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<sup>21</sup> Schedule 2, paragraph 1, of the Draft Determination.

<sup>22</sup> Orion has identified that as a result of reduced demand in 2011 and 2012 it was not able to fully recover the Transpower transmission charges relating to those years in its prices. It estimates that a total of \$7.7m of unrecovered pass-through costs will need to be recovered as a 'recoverable cost' in the regulatory period. This results from the catastrophic event and therefore should be treated as an exception to the general rule that pass-through costs for periods prior to the regulatory period should not be recovered as a pass-through cost or recoverable cost in the regulatory period.

from consumers. The amounts are tabulated in Schedule 2 of the Draft Determination.<sup>23</sup>

*Carried forward transmission charges may be adjusted for the time value of money*

- 3.25 Transpower transmission charges that are carried forward to the regulatory period as recoverable costs from 2011 and 2012 may be adjusted for the time value of money by linking the adjustment to the actual dates when the recoverable costs were paid and the date that revenue through prices is assumed to be received.
- 3.26 We have set the factor for making adjustments for the time value of money using the 5-year cost of debt rate (pre-corporate tax) that was used to determine the CPP WACC.

*Potential for recoverable costs to cause price shocks for consumers*

- 3.27 The recoverable costs allowable for Orion in 2015 (as described above) may end up being material relative to Orion's 2015 MAR. The Draft Determination does not currently include any price path smoothing mechanism, and therefore these amounts may lead to a significant price increase for consumers for 2015.
- 3.28 We will consider any submissions from interested persons on what steps should be taken to minimise the potential short-term price-shock effects on consumers.

**Price transition at the end of the CPP period**

- 3.29 The DPP determination that applies to all other non-exempt EDBs apart from Orion is due to expire on 31 March 2015 (ie, one year after Orion's CPP period commences).
- 3.30 The next DPP determination is scheduled to commence on 1 April 2015 and, assuming the standard 5 year term is determined by the Commission for that next DPP period, the DPP determination will expire on 31 March 2020 (ie, one year after Orion's CPP expires).
- 3.31 At the expiry of the CPP period, Orion will have the option of applying for a further Draft Determination (by applying at least one year before 1 April 2019) or will step onto the default price-quality path under the DPP determination for one year from 1 April 2019.<sup>24</sup>
- 3.32 In the event that a further Draft Determination does not follow the current Draft Determination, the Act specifies:

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<sup>23</sup> Schedule 2, Table 1, of the Draft Determination.

<sup>24</sup> Commerce Act 1986, s 53X.

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 4 months before the end of the customised price-quality path, the Commission advises the supplier that different starting prices must apply.<sup>25</sup>

- 3.33 As there are a number of key variables that may change between now and 1 April 2019, guidance on this matter is not currently reflected in the Draft Determination.

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<sup>25</sup> Commerce Act 1986, s 53X(2).



## 4. Quality standards compliance

### Compliance measurement

- 4.1 Orion will be required to comply with the quality standard compliance rule in each assessment period or the two immediately preceding assessment periods. This is based on the rule that applies to other EDBs under the EDB default price-quality path determination. However, in applying the ‘2-out-of-3’ test we will be recognising that Orion has already breached the quality standards under the default price-quality path in the period prior to the CPP regulatory period. The quality standard variation proposed by Orion and implemented by us for the regulatory period effectively wipes the slate clean and starts that test anew with effect from the start of the regulatory period.<sup>26</sup>
- 4.2 Under the compliance rule, Orion must carry out an annual reliability assessment using the following tests:
- 4.2.1 whether the assessed value of SAIDI exceeds the SAIDI limit; and
- 4.2.2 whether the assessed value of SAIFI exceeds the SAIFI limit.<sup>27</sup>

### Reliability limits

- 4.3 Orion proposed in its CPP proposal that a scale of steadily improving SAIDI and SAIFI reliability limits should apply over the regulatory period. This differs from the approach adopted in the EDB default price-quality path determination, where the reliability limits are set according to a formula in the determination based on historical performance in a reference period prior to the regulatory period.
- 4.4 The Commission assessed Orion’s expenditure proposals in its CPP proposal taking into account the reliability targets proposed. The Commission has accepted the reliability limits proposed by Orion and these are reflected as the reliability limits for measurement of quality standard compliance in the Draft Determination.<sup>28</sup>

### Assessed values

- 4.5 Orion will be required to measure its compliance with the quality standards by comparing the assessed values each assessment period for SAIDI and SAIFI against the reliability limits specified in the Draft Determination.

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<sup>26</sup> Clause 8.1 of the Draft Determination.

<sup>27</sup> SAIDI and SAIFI are the technical terms used to respectively measure the duration and frequency of service interruptions in Orion’s provision of electricity lines services to consumers. These are defined in clause 4.2 of the Draft Determination.

<sup>28</sup> Schedule 3, Table 3, of the Draft Determination.

- 4.6 The Draft Determination sets out the steps required to calculate the assessed values:
- 4.6.1 Orion must record a dataset of SAIDI and SAIFI values for the assessment period;
  - 4.6.2 The dataset must be normalised to remove the effect of ‘major event days’ that have the potential effect of distorting the SAIDI and SAIFI data;<sup>29</sup> and
  - 4.6.3 The SAIDI and SAFI assessed values are the sum of the normalised data points in each of the two datasets, which must be compared against the SAIDI and SAFI reliability limits respectively for the assessment period.

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<sup>29</sup> Schedule 3, paragraph 6 of the Draft Determination: where a value exceeds the boundary values set out in Table 4 of the Draft Determination, the actual value is replaced by the applicable specified boundary value. The boundary values were proposed by Orion in its CPP proposal and have been accepted by the Commission as being consistent with the reliability limits proposed by Orion and accepted by the Commission.

## Attachment A: Information requirements for large transactions

### Transactions with other EDBs must be included in Orion's compliance reporting

- A1 The compliance requirements for each assessment period contemplate scenarios where Orion might:
- A1.1 amalgamate with another EDB;
  - A1.2 merge with another EDB;
  - A1.3 take over another EDB;
  - A1.4 acquire assets from another EDB; or
  - A1.5 dispose of assets to another EDB.
- A2 All of these scenarios may affect the allowable notional revenue in an assessment period.

### *Notification of major transactions*

- A3 Orion must notify us within 30 working days of any large transactions, such as company amalgamations, mergers, or transfers of assets to or from another EDB, that occur during the regulatory period, and provide us with information regarding the transaction.<sup>30</sup>
- A4 The information provided will help us to understand the effect of the transactions on Orion's compliance, where there may be significant differences between one year and the next in the compliance with the customised price-quality path.
- A5 To ensure that this requirement focuses on only those transactions that might materially affect Orion's compliance with the customised price-quality path, we have limited this notification requirement to transactions where:
- A5.1 the regulatory investment value of Orion's assets is anticipated to increase or decrease by more than 10%; and
  - A5.2 Orion's revenues recovered through prices is anticipated to increase or decrease by more than 10% in an assessment period.

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<sup>30</sup> Clause 9.1 of the Draft Determination.

*Price path compliance following an amalgamation or merger*

- A6 A specific price path compliance treatment applies in the case of an amalgamation or merger that involves Orion and one or more other EDBs.<sup>31</sup>

*Compliance following the acquisition or disposal of assets*

- A7 Orion's allowable notional revenue will be adjusted in situations where it acquires assets from, or disposes of assets by transfer to, another EDB and if this results in consumers being supplied electricity lines services by a different provider (Orion or another EDB).<sup>32</sup> In particular:
- A7.1 Orion or the other EDB will be permitted to recover revenue from consumers for additional services that are supplied due to an acquisition.
- A7.2 Orion or the other EDB will not be permitted to recover revenue for services provided to customers they no longer supply.
- A7.3 The total prices for any additional services will not exceed the prices that were charged by the previous supplier, adjusted by inflation.<sup>33</sup>
- A8 Orion may also make adjustments to allowable notional revenue using an alternative compliance assessment approach, provided it has a substantially equivalent effect. An alternative may be necessary where Orion is unable to calculate the adjustment.<sup>34</sup>

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<sup>31</sup> The rules for the treatment of amalgamations between EDBs that are on different forms of default or customised price-quality paths are set out in clause 3.2.1 of the EDB IM Determination. The Draft Determination references these rules.

<sup>32</sup> Clause 9.3 of the Draft Determination.

<sup>33</sup> Schedule 1C of the Draft Determination.

<sup>34</sup> Clause 9.4 of the Draft Determination.

## Attachment B: Calculation of allowable notional revenue

### Allowable notional revenue is the benchmark against which compliance is assessed

- B1 Box B1 shows the inputs required to calculate allowable notional revenue for the first assessment period (2015).

#### Box B1: Price cap for the first assessment period (2015)

The allowable notional revenue for the first assessment period ( $ANR_{2015}$ ) is:

$$ANR_{2015} = \frac{MAR_{2015} + K_{2015} + V_{2015}}{\Delta D} - K_{2015} - V_{2015}$$

where:

$MAR_{2015}$	is the maximum allowable revenue for the First Assessment Period as specified in clause 7 of the Draft Determination of \$155.8 million
$\Delta D$	is the change in constant price revenue for the period 1 April 2013 to 31 March 2015 as specified in clause 7 of the Draft Determination of 1.016
$K_{2015}$	is the sum of all Pass-Through Costs relating to the First Assessment Period (ie, 2015)
$V_{2015}$	is the sum of all Recoverable Costs relating to the First Assessment Period, adjusted to exclude the carried forward amounts relating to the 2011 and 2012 unrecovered transmission charges in Schedule 2, paragraph 4(a) of the Draft Determination.

- B2 Box B2 sets out the mathematical derivation of the allowable notional revenue formula set out in Box B1.

#### Box B2: Derivation of the ANR formula for the first assessment period (2015)

Maximum allowable revenues are expressed in terms of allowed prices multiplied by a set of corresponding quantities. As we do not limit the amount of pass-through and recoverable costs that are passed on to consumers, we must remove the pass-through and recoverable cost components that are included in the prices:

$$MAR \equiv \sum_i P_{i,t} Q_{i,t} - K_t - V_t$$

Adding pass-through and recoverable costs to both sides of the equation gives:

$$MAR + (K_t + V_t) = \sum_i P_{i,t} Q_{i,t}$$

If we then divide both sides of the equation by  $\Delta D$  (which is the change in constant price revenue or change in quantities), we derive the following:

$$\Delta D = \Delta Q_{i,t-2} \Delta Q_{i,t-1} \text{ and}$$

$$\frac{MAR + (K_t + V_t)}{\Delta D} = \sum_i P_{i,t} Q_{i,t-2}$$

Subtracting pass-through and recoverable costs from both sides of the equation gives:

$$\frac{MAR + K_t + V_t}{\Delta D} - K_t - V_t = \sum_i P_{i,t} Q_{i,t-2} - K_t - V_t = ANR_t$$

The left side of this equation is how Orion will calculate its allowable notional revenue for 2014/15, while the middle is how we specify notional revenue.

B3 Box B3 shows the inputs required to calculate allowable notional revenue for the subsequent assessment periods.

### Box B3: Price cap for assessment periods other than the first (2016 to 2019)

The allowable notional revenue for the assessment period  $t$  ( $ANR_t$ ) is:

$$ANR_t = \left( \sum_i P_{i,t-1} Q_{i,t-2} - (K_{t-1} + V_{t-1}) + (ANR_{t-1} - NR_{t-1}) \right) (1 + \Delta CPI_t) (1 - X)$$

where:

$t$	is the year in which the assessment period ends;
$i$	is each Price relating to a electricity lines service;
$P_{i,t-1}$	is the $i$ th Price for any part of assessment period $t$ ;
$Q_{i,t-2}$	is the Quantity corresponding to the $i$ th Price for the assessment period $t$
$K_{t-1} + V_{t-1}$	is the sum of all Pass-through Costs and Recoverable Costs for the assessment period $t$
$ANR_{t-1} - NR_{t-1}$	is the difference between allowable notional revenue and notional revenue for the assessment period $t$ (see Attachment D)
$X$	is the X-factor rate of change of 0%
$\Delta CPI_t$	is the derived change in the CPI to be applied for the assessment period $t$ .

- B4 The equation for these later assessment periods has the following features:
- B4.1 allowable notional revenue is expressed as a general formula that applies for the second and subsequent assessment periods;
  - B4.2 allowable notional revenue is a function of prices from the previous assessment period and a corresponding set of quantities lagged by two years for the second and subsequent assessment periods, rather than allowable notional revenue from the previous assessment period; and
  - B4.3 the revenue differential term is included for the second and subsequent assessment periods (see further details in Attachment D).

## Attachment C: Calculation of notional revenue

- C1 Notional revenue can be calculated when prices are set because the calculation uses known values. It uses:
- C1.1 known quantities from two years prior to the assessment period, which are the most recently known quantities when prices are set; and
  - C1.2 known Pass-through Costs and Recoverable Costs.
- C2 When calculating notional revenue at the end of an assessment period, the prices must reflect the prices charged during the assessment period. If prices changed during the period, then those prices must be weighted accordingly.

### Box C1: Calculating notional revenue in each assessment period

Notional revenue for a pricing year ending in year  $t$  ( $NR_t$ ) is:

$$NR_t = \sum_i P_{i,t} Q_{i,t-2} - K_t - V_t$$

where:

$t$	is the year in which the assessment year ends
$i$	is each price relating to an electricity lines service
$P_{i,t}$	is the $i^{\text{th}}$ price for any part of the assessment period $t$
$Q_{i,t-2}$	is the quantity corresponding to the $i^{\text{th}}$ price during the assessment period ending two years prior to assessment period $t$
$K_t$	is the sum of all Pass-through Costs for the assessment period $t$ .
$V_t$	is the sum of all Recoverable Costs for the assessment period $t$ .



## Attachment D: Explanation of the revenue differential term

### What is the revenue differential term?

D1 The revenue differential term (RDT) is the  $(ANR_{t-1} - NR_{t-1})$  term contained in the allowable notional revenue formula in Schedule 1B of the Draft Determination.

### Purpose of the RDT

D2 The RDT exists to prevent:

D2.1 an over-recovery (ie, a situation where notional revenue exceeds allowable notional revenue) in one assessment period from increasing allowable notional revenue in the next assessment period; and

D2.2 an under-recovery (ie, a situation where notional revenue is less than allowable notional revenue) in one assessment period from lowering allowable notional revenue in the next assessment period.

D3 Without the RDT:

D3.1 an over-recovery in one period would increase allowable notional revenue in the next period. As a result, Orion would not only receive the over-recovery in the period of the over-recovery, but would also receive an increased allowable notional revenue in the next period; and

D3.2 an under-recovery in one period would decrease allowable notional revenue in the next period.

### What the RDT does and does not do

D4 The RDT ensures that allowable notional revenue is unaffected by an under- or over-recovery in the previous period.

D5 The RDT does not decrease allowable notional revenue to compensate for an over-recovery in the previous period. Likewise, the RDT does not increase allowable notional revenue to compensate for an under-recovery in the previous period.

D6 Because the RDT does not lower allowable notional revenue following an over-recovery, it does not automatically return to consumers the amount of an over-recovery.

### **An example to illustrate how the RDT works**

D7 The following simplified example illustrates the effect of the RDT.

#### *Assumptions*

D8 Assuming that:

D8.1 allowable notional revenue ( $ANR_{2015}$ ) for 2015 is \$100;

D8.2 notional revenue ( $NR_{2015}$ ) for 2015 is \$120.

D9 As such, the lines business exceeded  $ANR_{2015}$  by \$20.

D10 If for the example we also assume the  $\Delta CPI$ , the X factor and the amount of pass-through and recoverable costs ( $K$  and  $V$ ) are equal to zero, we can ignore those terms in the calculation.

D11 We also assume for this illustration that quantity does not change over time.

#### *Results of calculations*

D12 Without the RDT, allowable notional revenue for 2016 ( $R_{2016}$ ) would increase to \$120, because it is equal to the previous year's notional revenue ( $NR_{2015}$ ).

D13 The RDT prevents the over-recovery of \$20 from flowing through and increasing  $R_{2016}$  to \$120, instead keeping it at \$100. Without the RDT,  $R_{2016}$  would be increased to \$120 as the pricing decision made for the 2015 year would have affected allowable notional revenue in 2016. The RDT has ensured that allowable notional revenue remains at the level where it would have been had the over-recovery not occurred.

D14 The RDT has not automatically returned the 2015 over-recovery to consumers. To do so, the RDT would need to be specified differently: it would need to reduce  $R_{2016}$ . For the 2015 over-recovery to be returned to consumers,  $R_{2016}$  would need to be reduced to \$80 (ignoring the concept of time value of money).

D15 When calculating notional revenue at the end of an assessment period, the prices must reflect the prices charged during the period. If prices changed during the period, then those prices must be weighted accordingly.