

15 August 2014

Regulation Branch  
Commerce Commission  
P O Box 2351  
Wellington 6140

*by email:* regulation.branch@comcom.govt.nz

### **SUBMISSION ON THE LOW COST FORECASTING APPROACHES FOR DPP**

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to provide a submission on the Commerce Commission's (**Commission**) proposed low cost forecasting approaches 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 and provided expert reports. While not all of the ENA's comments apply to Orion at this time we endorse the ENA submission, to the extent that it applies to Orion now and for future DPP resets.

### **Orion specific issues**

- 3 Orion is currently operating under a customised price path (CPP) and will become subject to the default price path (DPP) that is generally applicable to other suppliers of those goods or service from 1 April 2019 unless Orion applies for another CPP.
- 4 If we return to the DPP at the end of the CPP regulatory period this will be for one year only before the DPP is reset.
- 5 If the Commission decides to set Orion's prices for the final year of the DPP based on current and future profitability, the Commission will have to forecast Orion's operating expenditure and capital expenditure for that year.

- 6 The Commission has indicated<sup>1</sup> that its current view is that it will rely on up-to-date forecasts of operating and capital expenditure that take into account efficiency gains achieved under the CPP.
- 7 However, it has provided no explanation at this stage on the approach it might take in regard to this forecast.
- 8 As explained in our submission on the Commission's main policy paper the Commission has indicated that it intends to start consultation with Orion New Zealand on transition back to the default price-quality path at least 24 months before the end of our CPP as requested by Orion.<sup>2</sup> Since that time we have reflected on the timeframes required should we wish to seek a further CPP and have reached the conclusion that a longer period would be more appropriate.
- 9 We consider that the Commission should set out the approach that it proposes to adopt for Orion and have that process completed by January 2016. Orion also submits that the other option of rolling over prices should be considered as part of the consultatuion process.

#### *Forecasts of capital expenditure*

- 10 As the Commission is aware, Orion will have a significant amount of capital expenditure over the CPP period with the exact timing of some of this expenditure is subject to change given our circumstances. Our CPP proposal relied on forecasts produced in a volatile and uncertain post-quake environment. In addition much of our activity and therefore timing of spend is driven by third parties – for example the pace of the wider city rebuild. A number of rural projects are being delayed due to circumstances beyond our control. Due to this we do not consider that the Commissions proposed approach to capex forecasts for 16 EDB's to cap forecast expenditure based on the difference between their previous historic forecasts and their actual out-turns will be appropriate for Orion either for the transition to the DPP or the following DPP reset.
- 11 The CPP forecast and out-turns will be atypical as a result of our response to the catastrophic earthquakes experienced in 2011 and we do not consider that any divergence from the Commission's forecast can be used to limit future forecasts, particularly as there was a significant difference between the Commission's and Orion's forecasts regarding the appropriate level of expenditure.
- 12 We consider that the Commission should use the most up-to-date data - i.e the 2018 year - as a base for any forecasts and we look forward to constructive consultation on how the Commission considers that they will forecast Orion's capex, not just for the

---

<sup>1</sup> Paragraph A9

<sup>2</sup> Orion New Zealand "submission on the default price quality path from 1 April 2015 for 17 distributors – process and issues paper" 30 April 2014. Paragraph 8

single year of the DPP (should prices not be rolled over) but also for the next DPP reset.

- 13 While we accept that the reset of the DPP is a relatively low cost general approach and is not intended to be customised to each EDB, we consider that it is necessary that any forecasting methodology that the Commission uses should be based on more than what appears to be arbitrary caps.
- 14 In particular, any forecasting methodology that the Commission uses must be able to deal with the potential volatility that exists following a catastrophic event in such a manner so that, at the end of our CPP, we can realistically move back to a DPP and not be forced into a second CPP as a result of inadequacies in forecasting.
- 15 The Commission's proposal to arbitrarily cap an EDBs forecast of capex over the 5 year regulatory period to either 120% or to 110% of the average based on whether the EDB's historic forecasts of capex diverges from actuals historic spend by less than 10% or more than 10% needs more justification.
- 16 We acknowledge that this general approach of capping the forecast was proposed by Vector, however we consider that before adopting such an approach, the Commission should have carried out reasonable analysis and testing against historical data and provided an evidence backed explanation to support its proposed limits. We consider that this is particularly the case when the capex forecast is over-laid with an IRIS scheme. Clearly this requires a forecast that has some reasonable basis.
- 17 We also submit that the Commission should consider rolling over Orion's prices for the final year of the DPP and we note that this would be consistent with the Commission's proposal to roll over our reliability targets.

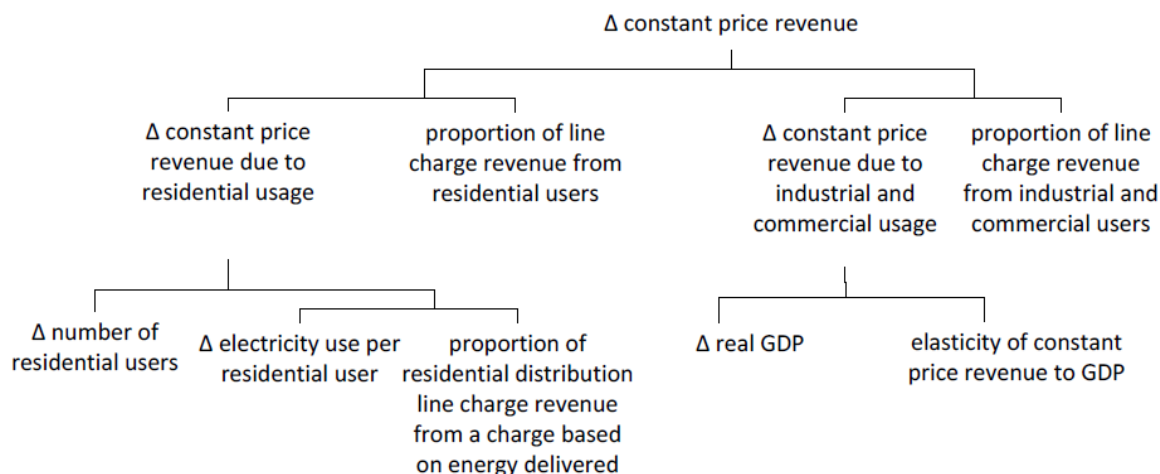
#### *Forecasts of operating expenditure*

- 18 We consider that the forecasting opex has similar issues. The Commission has proposed to forecast opex by projecting forward an initial base year opex allowance based on changes to three main drivers:
  - 18.1 network scale,
  - 18.2 partial productivity; and
  - 18.3 input prices.
- 19 Again, in Orion's case, we consider that our most up-to-date AMP forecast will be the most appropriate reference point on which the Commission should base any forecasts.
- 20 We concur with the ENA's recommendation that consideration should be given to using historic ICP data in place of population forecasts to generate ICP projections.

We also support the ENA's recommendation that the Commission should pursue other improvements in input price forecasting.

### *Revenue Growth*

- 21 The Commission's to modelling forecasting revenue growth is set out in the figure below.



- 22 The Commission proposes to model constant price revenue growth separately for residential users, and industrial and commercial users. The Commission has classified revenue into those two categories based on information provided by distributors in response to an information gathering request.

- 23 We have previously explained to the Commission<sup>3</sup> that:

23.1 we do not use categories such as residential or commercial and industrial. It would be a significant process to combine the information that we have to provide the information in the categories required by the Commission that this effectively makes the categories meaningless in terms of applying different growth drivers.

23.2 Pricing structure changes, such as those implemented by Orion from 1 April 2009, can make the use of actual historical quantity data problematic for forecasting. Estimates of historical volumes on the new basis are inevitable in this case, but these could easily have a different relationship with external factors than did the no longer relevant actual volumes.

23.3 Distributors' chargeable quantities (be they energy volumes, connection numbers, peak demands or whatever) will almost certainly be linked to

<sup>3</sup> Letter in response to the Commission section 53ZD notice of the Commerce Act 1986 issued 18 April 2012 requiring us to supply information on residential and commercial and industrial usage

developments in the external environment (such as population growth, economic growth; energy efficiency and technology change to name a few).

- 23.4 To the extent that the external factors can be measured, a relationship between them and the chargeable quantities can certainly be estimated, but that does not mean that the relationship is directly proportional. For example even if population growth is the sole and direct driver of fixed revenue growth, and population growth can itself be exactly predicted, that does not make projections of population growth an applicable factor unless the relationship itself is known. It cannot reasonably be assumed to be 1 to 1.
- 23.5 If such a relationship can be properly established - for example using regression analysis - then there is no need to segment distributors' chargeable quantities: the Commission only need to acquire historical movements in chargeable quantities (appropriately weighted) as the dependent variable and regress these against the independent variables. The relationships (and their statistical properties) will emerge as the coefficients and standard errors of the regression analysis.
- 23.6 Alternatively, particularly given the uncertainty of forecasts of the independent variables, the Commission could rely simply on the trends in the chargeable quantities themselves, which is how Orion (at least in a non-earthquake environment) goes about conducting its quantity forecasting.

#### *Transition to the DPP and the 2020 DPP reset*

- 24 For the reasons outlined above we consider that it will not be practical to apply the type of models proposed for the 2015 reset to Orion for the transition back to the DPP. We also have serious concerns about applying such an approach one year later for the reset of the DPP. We therefore look forward to a constructive consultation with the Commission on how these matters may be resolved.


#### **General Issues**

- 25 The ENA is submitting on the wider scope of the paper as it relates to the DPP reset we support the ENA's submission to the extent that it applies to Orion now and for future DPP resets.

#### **26 Concluding remarks**

- 27 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](mailto:Dennis.Jones@oriongroup.co.nz).

Yours sincerely

A handwritten signature in black ink that reads "D. L. Jones". The letters are cursive and slightly slanted to the right.

Dennis Jones  
**Industry Developments Manager - Commercial**