

# Orion's Customised Price-Quality Path (CPP) Draft Decision

**Briefing**  
**14 August 2013**

# Overview



- Today we published our draft decision setting Orion's customised price-quality path (CPP)
- The purpose of this briefing is to provide an overview of our draft decision

# What I'm going to cover

- What is a customised price-quality path?
- Circumstances of Orion's proposal
- Key features of Orion's proposal
- Key features of our draft decision
- Expert advice from Strata Energy
- The process we followed, and our approach
- Next steps

# Customised price-quality path (CPP)



- All regulated suppliers start on a default price-quality path
  - We set average starting prices and allowed increases over five year regulatory period using low cost approach
  - We set quality standards suppliers have to meet
  - Supplier can propose CPP to better meet their particular circumstances
- Customised price-quality path has same elements as DPP
  - But path can be tailored to specific circumstances of a supplier
  - Can involve changes to price path, quality or regulatory period

# Circumstances of Orion's CPP proposal



- Response to the Canterbury earthquakes
- First customised price quality proposal
- Prepared in difficult circumstances and in short timeframe
- Future is uncertain due to:
  - Speed of rebuild
  - Location of demand
  - Pressure on contractor costs

# Key features of Orion's proposal



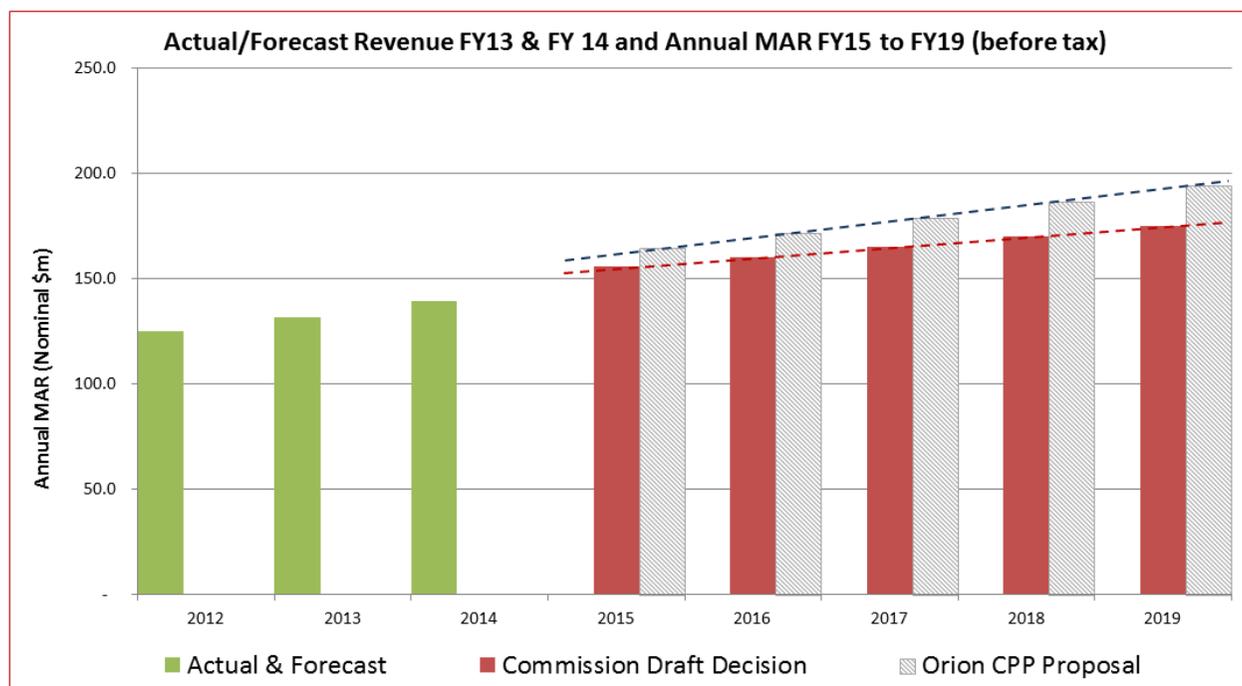
- Orion sought to:
  - Recover additional costs and lost revenues after the earthquakes but prior to the proposed CPP taking effect (claw-back)
  - Invest to meet changes in demand
  - Invest to return network reliability to near pre-earthquake levels by 2019
  - Invest to increase network resilience to high-impact low-probability events
  - Significantly increase replacement capex and some opex
- Orion's proposed price-quality path:
  - Five year regulatory period
  - Prices increase by 15% + CPI in 2014/15
  - Annual price increases of CPI+1.2% to 2019
  - Reduce quality standards (but increase these over period)
  - Defer recovery of \$70 million to following regulatory period

# Key features of our draft decision



- Our draft decision provides for Orion to:
  - Recover most costs incurred after the earthquakes but not lower than expected revenue
  - Invest to meet changes in demand and some increases in network reliability (back towards pre-earthquake levels by 2019)
  - Defer substantial investment in resilience
  - Increase replacement capex and opex (but by less than Orion proposed)
- Draft customised price-quality path:
  - Five year regulatory period
  - Prices increase by 9.2% + CPI in 2014/15
  - Annual price increases of CPI to 2019
  - Quality standards as proposed by Orion
  - No deferral of cost recovery to next regulatory period

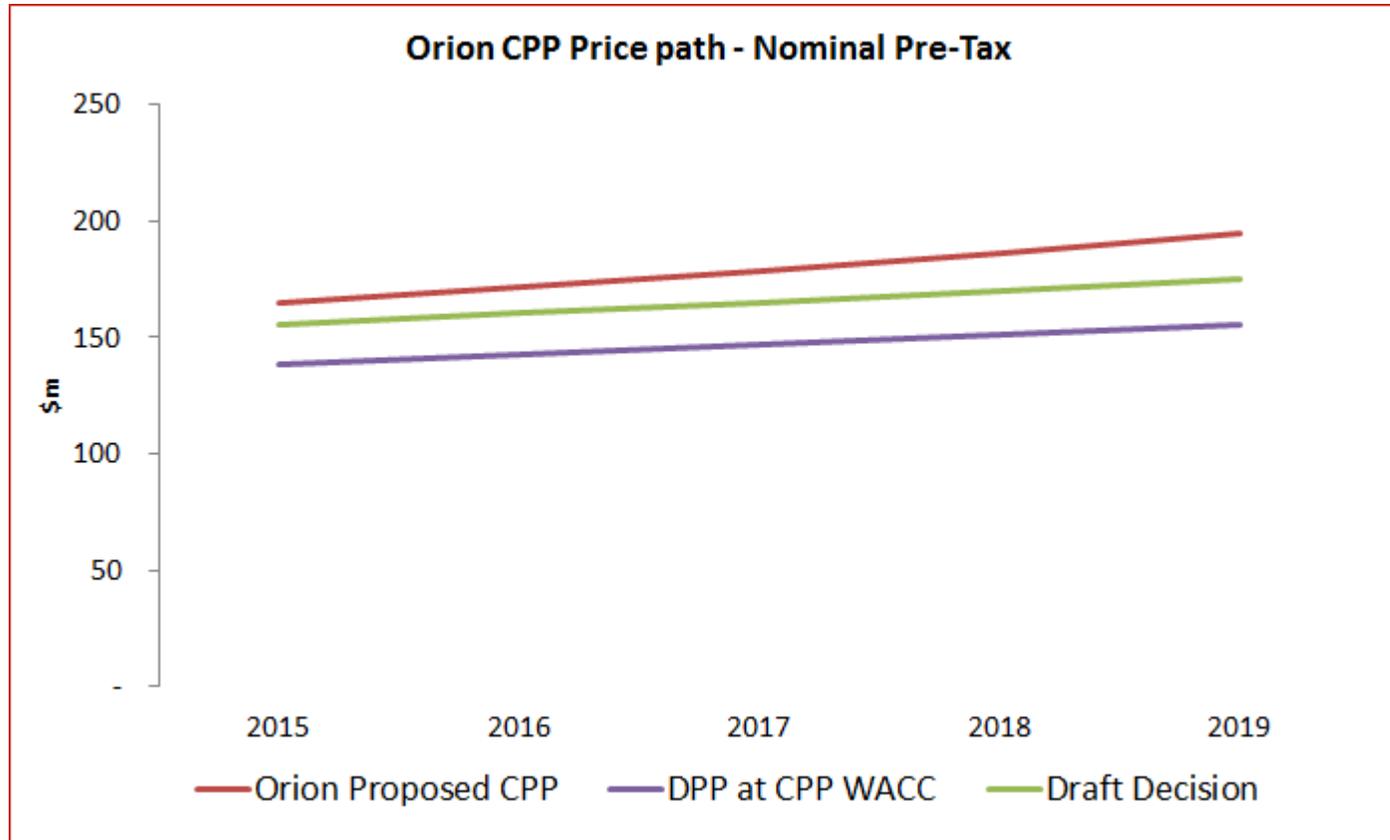
# We are allowing a smaller increase in revenue than Orion proposed



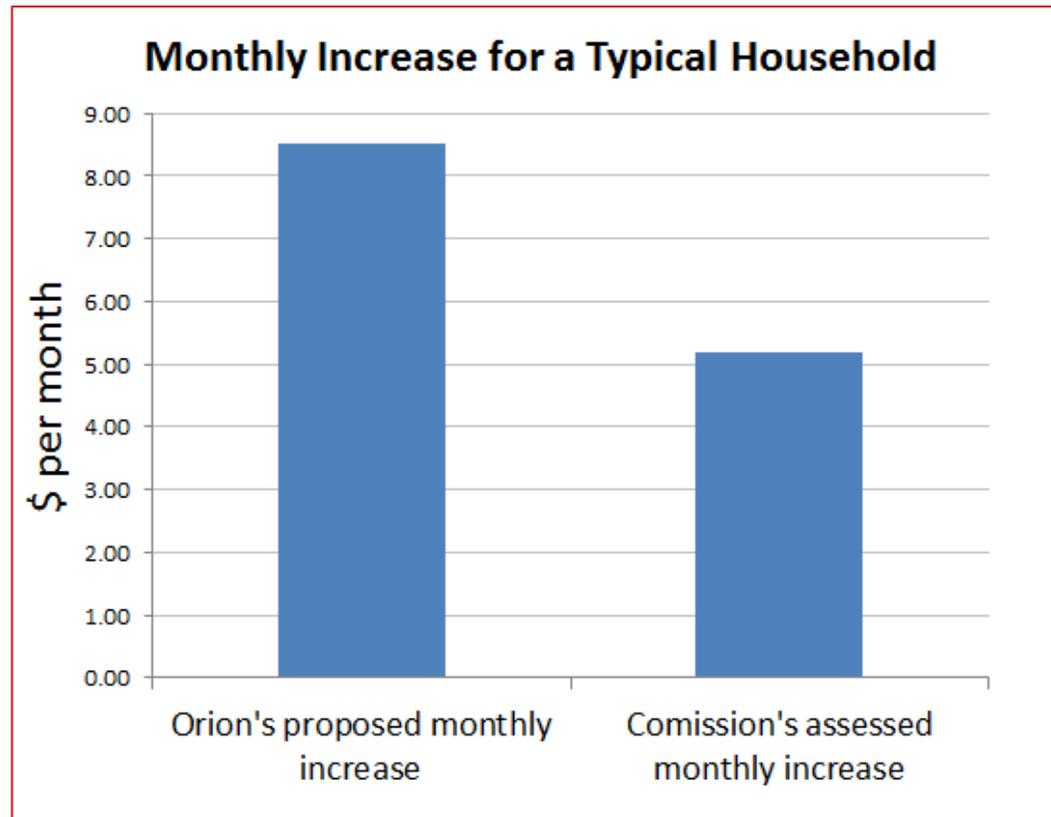
**Table 5.12 - Maximum allowable revenue (\$m) – nominal values**

	2015	2016	2017	2018	2019
Orion's proposal	\$164.8m	\$171.7m	\$178.9m	\$186.6m	\$194.4m
Our draft decision	<b>\$155.8m</b>	<b>\$160.4m</b>	<b>\$165.2m</b>	<b>\$170.2m</b>	<b>\$175.2m</b>
Difference	\$(9.0)m	\$(11.3)m	\$(13.7)m	\$(16.4)m	\$(19.2)m

# Our decision is less than Orion proposed, but more than the DPP

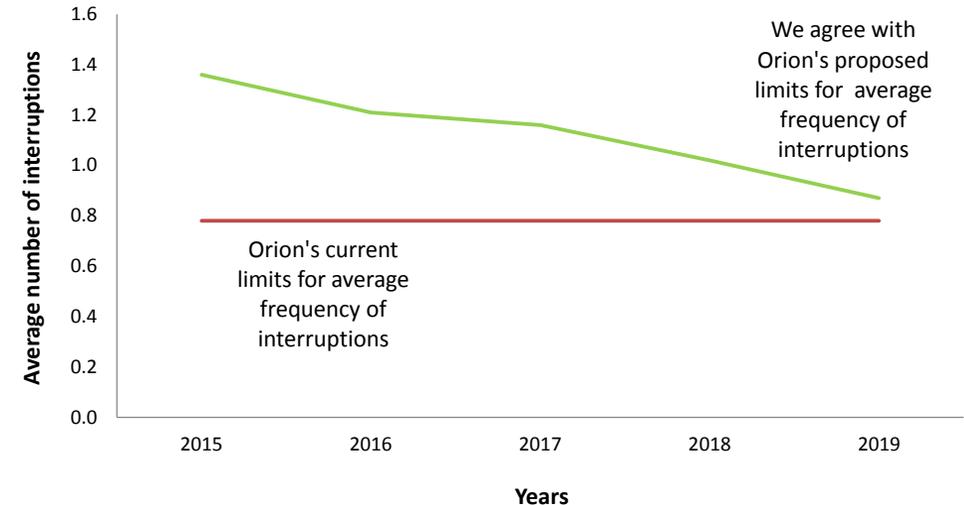
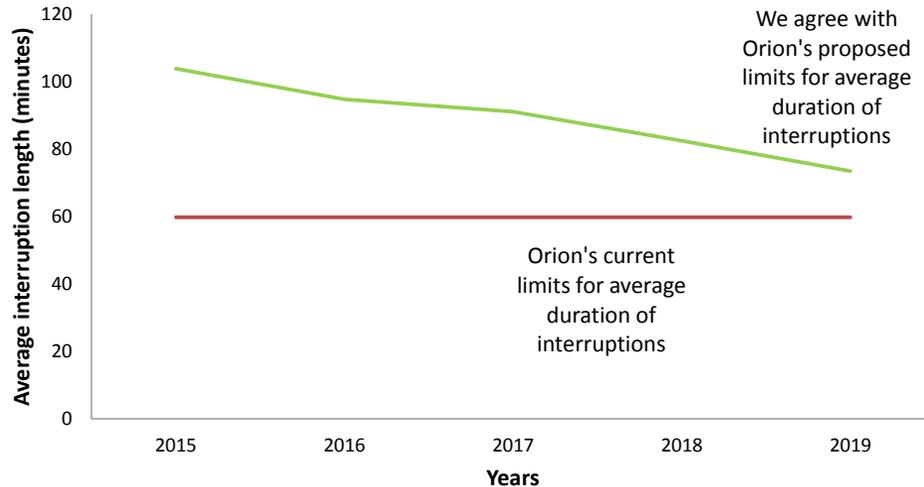


# Impact on consumers: Price



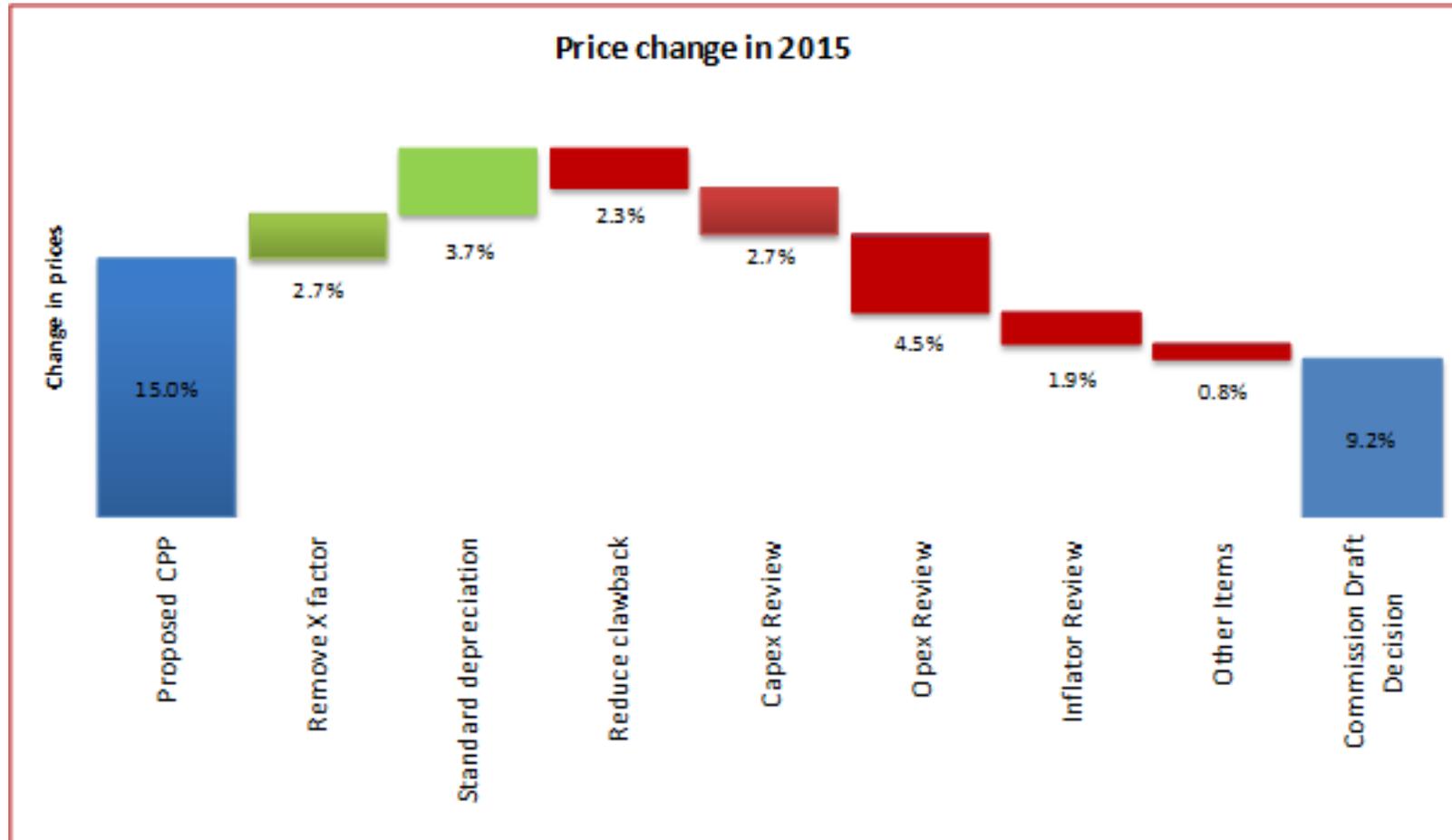
- Orion estimated that the typical household's monthly electricity bill would increase by \$8.50 per month. The Commission's decision reduces this to \$5.20 per month.

# Impact on consumers: reliability

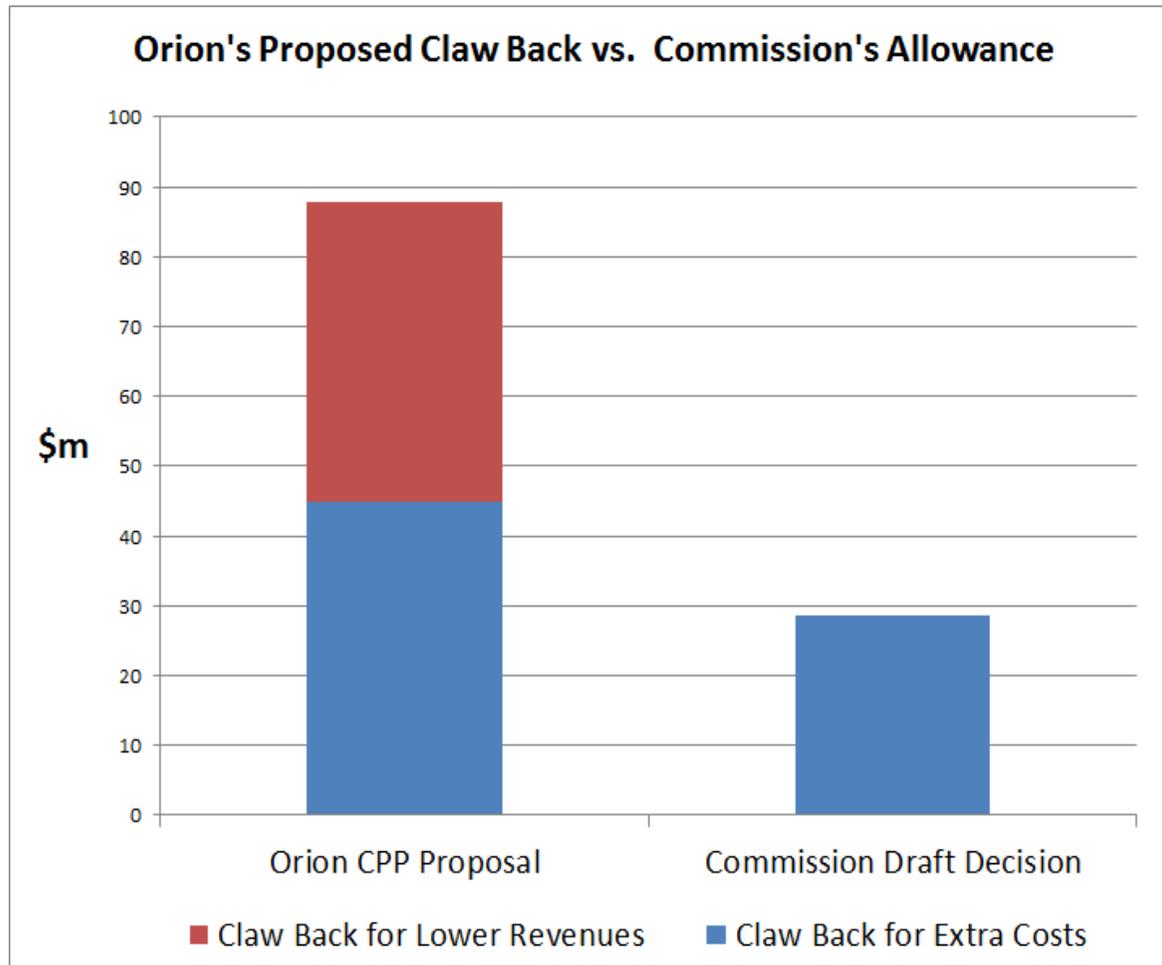


- The minimum quality targets Orion must meet are less stringent than prior to the earthquakes
- Gradual improvement over the CPP period will be required

# The adjustments we have made



# Adjustments: claw-back



- Claw-back refers to costs incurred and revenue foregone before reset of price path
- Orion proposed \$86m claw-back
- We have allowed \$28m for costs incurred
- We have not allowed recovery of lost revenue

# Adjustments: claw-back (cont.)

- We think the risks and costs of the earthquakes should be shared between Orion and consumers
  - Provides incentives to manage risks
- We propose to allow Orion to recover opex and capex costs incurred as a result of the earthquakes prior to reset (\$28.6 million)
  - Can recover actual costs incurred in 2011, 2012 and 2013
  - Actuals for 2013 were \$8 million lower than Orion's forecast
  - Have applied prudence test to 2014 expenditure
- Have not allowed recovery of lower than expected revenue
  - Demand risk normally borne by suppliers in workably competitive markets

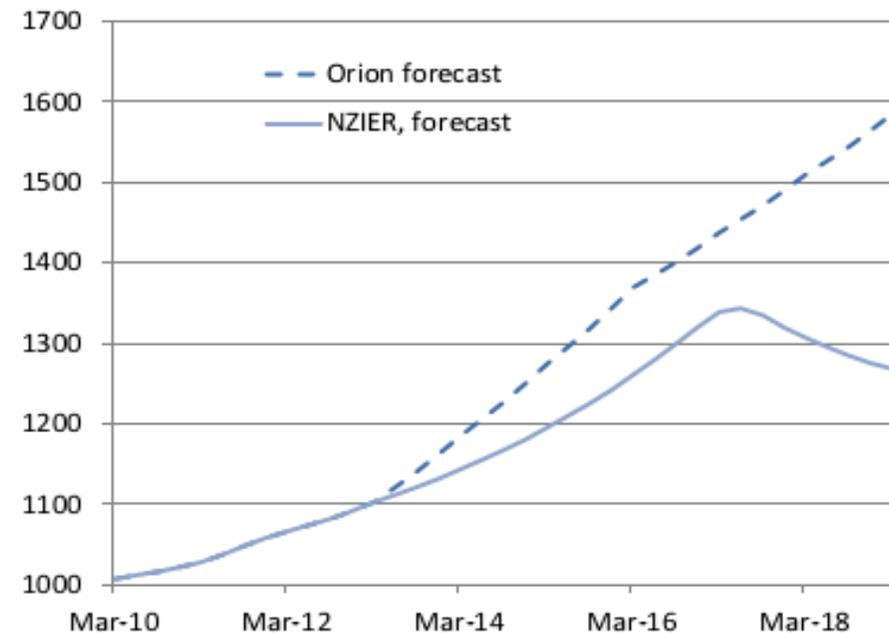
# Adjustments: opex and capex

- In our view Orion is proposing to do too much, too soon
  - We agree that Orion should be allowed more income for growth as demand changes
  - Expenditure should be staged over a longer period
  - Some expenditure is not well justified (eg replacement capex)
  - A smaller increase in expenditure would provide a better price quality trade-off for consumers
- Orion will decide what work is undertaken and when
- Expert advice from Strata

# Adjustments: cost escalators

- Orion proposed increases of 7.5% per annum to 2016 and then 5% per annum for field labour costs
- Based on forecasts we commissioned from NZIER we use lower assumptions

Indices, annual averages



# Our process to date

- **20 February** – Orion’s proposal received
- **19 April** – We conclude Orion’s proposal is complete and commence our formal evaluation against IM criteria
- **1 May** – ‘Issues to explore and consider’ paper released
- **May-July** – Continued evaluation of main areas of focus, plus:
  - Consideration of submissions received
  - Expert reports on claw-back issues and insurance review issued for comment
- **14 August** – Draft decision issued
- Regular engagement with Orion staff throughout, evaluation conducted on ‘no surprises’ basis

# Our approach

- We drew on a number of sources to identify key issues
  - Independent verifier, our review, expert input
  - We sought submissions from stakeholders on issues paper and Orion's proposal - wide range of views
- We made extensive use of both internal expertise and external advisors
  - Prof Yarrow, an international regulatory expert for claw-back
  - AON on insurance matters
  - Geoff Brown & Associates (the independent verifier)
  - Strata and Partna Consulting on engineering matters
  - NZIER on labour cost forecasts
  - Calverton on undergrounding costs

# Our approach (cont.)

- We evaluated CPP proposal against criteria in IMs
  - Whether the proposal is consistent with the input methodologies
  - The extent to which the proposal promotes the purpose of Part 4
  - Whether data, analysis, and assumptions underpinning the proposal are robust, accurate, reliable and appropriate
  - Whether proposed expenditure is prudent for the expected energy demand on the applicant's network, reflects appropriate service standards, and is sufficient to meet regulatory obligations (“expenditure objective”)
  - The extent to which any proposed changes to the applicant's quality standards reflect what the applicant can realistically achieve
  - The extent to which the proposal is supported by consumers, where relevant

# Our approach (cont.)

- Evaluation of Orion's proposal against the IM criteria
  - We began with a top down analysis
  - Orion's proposal did not meet the expenditure objective
  - We therefore had to undertake a much more detailed review of expenditure in which we considered feasible alternatives including trade-offs between price and quality/resilience
- Long-term benefit of Orion's consumers key focus

# Next steps

- This is a draft decision
- Before we issue our final decision, we want to hear and consider your views
  - Submissions are due by on 20 September 2013
  - Cross submissions are due on 11 October 2013
  - Our final determination will be published by 29 November 2013

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For more information ...



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Additional information on Orion's CPP application, and our draft decision, is available from our website:

<http://www.comcom.govt.nz/orion-cpp/>

For any enquiries, please email us:

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