4 August 2016

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Submission on Input methodologies review - draft decisions

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the Commerce Commission's (the **Commission**) draft decisions on the Input Methodologies (IM) review. This submission responds to the Report on the IM review released on 22 June 2016 and selected parts of the 10 papers released on 16 June 2016 (collectively the **draft decisions**). It does not formally respond to the draft determination released on 22 June 2016, but refers to the drafting where that is necessary to understand the policy intent.

2 In particular, we comment on the following papers:

2.1 Framework for the IM review

2.2 Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower

2.3 Topic paper 2 – CPP requirements

2.4 Topic paper 3 – The future impact of emerging technologies in the energy sector

2.5 Topic paper 4 – Cost of capital issues

2.6 Topic paper 7 – Related party transactions

2.7 Report on the IM review.

3 We have also reviewed the consultation paper on applying the IMs to gas pipeline businesses' default price-quality path (**DPP**), as this indicates how a pure revenue cap may be applied.

4 There are overlaps across the consultation material with some topics covered in the topic papers also being covered in the Report on the IM review, which goes through each IM. This submission is structured as follows:

4.1 First, we discuss broader, over-arching issues – the Framework for the IM review and emerging technologies;

4.2 Second, we discuss each IM in an order that broadly reflects the materiality of changes being considered in this review:

(a) Cost of capital

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(b) Specification of price (including form of control), DPP reopeners and the incremental rolling incentive scheme (**IRIS**)

(c) CPP requirements

(d) Asset valuation (including indexation of the regulatory asset base (**RAB**))

(e) Cost allocation

(f) Next closest alternative (**NCA**) proposal

(g) Related party transactions

(h) Taxation.

5 We have reviewed and support the submission by the Electricity Networks Association (the **ENA**) on these consultation papers.

Summary of our submission

6 We support much in the draft decisions package, although we believe that some areas need improvement and/or clarification.

7 In particular, we support the following aspects of the draft decisions:

7.1 The decision not to restrict EDBs' investments in emerging technologies through Part 4 regulation. This will likely deliver better outcomes for consumers by enabling EDBs to adopt new technologies to deliver improved electricity distribution services.

7.2 We agree that market separation rules to address boundaries between regulated and unregulated services, as proposed by some submitters, cannot be imposed under Part 4.

7.3 The change from a price cap to a revenue cap for EDBs. This will deliver benefits to consumers and suppliers by making it easier to restructure prices and removing the risks caused by errors in forecasting demand at each price reset. We believe that the concerns raised by the Electricity Authority (**Authority**) regarding pricing efficiency under a revenue cap are not well founded.

7.4 The ability of EDBs to apply for a reduction in asset lives of up to 15% where the asset is at risk of stranding. We request further clarity on how applications for this will be assessed and we submit that it should be possible to reduce an asset's life more than once, or by a greater amount that 15% where this can be justified.

7.5 The proposals to reduce the costs and complexity of CPPs, although further refinements and improvements are required to make them workable, remove ambiguity in the drafting and to further reduce unnecessary compliance costs.

7.6 The improvements in the ways DPPs and CPPs work together, including:

(a) Full alignment of CPP and DPP WACCs

(b) introducing a DPP reopeners for quality standards.

7.7 Retaining the 0.34 asset beta for EDBs.

7.8 The majority of the detailed changes that are discussed in the Report on the IM review. These are generally non-controversial.

8 We are concerned that the draft decisions and the Report on IM Review do not correctly reflect the status of our current asymmetric CPP IRIS and could be interpreted as indicating that we will not be able to apply an IRIS recoverable cost in the year ending 31 Mar 2020[1]. We consider that the Commission has clarified its position on this in the draft report on our transition to the 2015-2020 DPP and has confirmed we expect to be able to recover the benefits from our existing IRIS from 1 April 2019 (i.e. after the CPP ends). We discuss this further below at paras 70 to 73.

9 We would like to better understand or further consider the concerns raised in the draft decision regarding trends in related party transactions. The Commission appears concerned that related party costs have increased since 2012, but on the contrary our related party costs have declined since then.

10 We do not support the following aspects of the draft decisions:

10.1 The introduction of a “cap on wash-up amount” which is intended to make suppliers bear a portion of the loss resulting from a major drop in demand. The Commission’s proposal, is that for EDB’s, it is ex ante providing an expectation of a real return (FCM) under a revenue path. A cap on wash-up amounts where some portion of losses following a catastrophic event is borne by the supplier is inconsistent with this.

The Commission’s approach is based on a decision on Orion’s CPP that consumers and suppliers should share the risk of catastrophic events. We do not consider that this decision can simply be carried across to a different form of control for the reasons outlined in paragraphs 50 and 51.

The Commission’s approach could incentivise EDB’s to concentrate resources on a CPP application following a catastrophic event to minimise the timeframe that suppliers are exposed to reduced revenue at a time when resources are constrained.

We also note that the Commission is not proposing a “cap on wash-up amount” to be applied in respect of the Transpower revenue cap. We consider this is the correct approach and the Commission should be adopting the same approach in respect of EDBs. Clearly different approaches cannot be consistent with Part 4.

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[1] Report on the IM review, 22 June 2016, paragraph 452.

10.2 That no changes are required to the Commission's approach to RAB indexation for EDBs. We agree with the ENA's submission regarding the implications of continuing with RAB indexation for EDBs' future ability to fund debt servicing obligations.

10.3 The emerging technologies topic paper indicates that, depending on technology change, suppliers may be unable to recover the full cost of their investments. This actively undermines regulatory certainty and the ex-ante expectation of earning real FCM – it seriously undermines incentives to continue to invest in the long term interests of consumers.

10.4 The variety of wash-ups proposed to be applied as part of the revenue cap. Some of these wash-ups overlap and conflict. Others are inconsistent with the intent of a revenue cap to allow EDBs to fully recover their revenue requirement. We support a simplified wash-up regime, preferably with just one mechanism that washes up for differences between actual and allowed revenues.

10.5 The requirement for CPP applicant to prepare a summary of the CPP proposal at the time the verifier is engaged, and again at the time the verifier submits its draft report. This adds undue cost, and is a distraction for the applicant during the critical CPP proposal development period. It also exposes the applicant to Commission scrutiny well before this is necessary. The Commission has other options to help it undertake its assessment of the application, including more comprehensive use of the verifier after the application is submitted.

10.6 The retention of the prevailing method for determining the risk free rate and debt premium components of the cost of debt for the cost of capital. We support a trailing average approach, which has been adopted by regulators in other jurisdictions; reduces volatility in regulatory cost of capital estimates over time; and better reflects the realistically achievable and efficient borrowing practices of EDBs.

Framework for the IM review

11 In our August 2015 submission on the problem definition consultation we indicated our support for frameworks that provide clear guidance for industry and other stakeholders of when the Commission is likely to amend the IMs and how the Commission will approach decisions about amending the IMs.[2] We thought the draft guidelines for changing the IMs published at that time by the Commission were helpful but could be improved.

12 The draft decision in terms of the framework for reviewing the IMs does not seem materially different from the draft guidelines published last year. The Commission continues to reserve discretion on when to change the IMs and appears unwilling to apply any clear materiality threshold. We agree that an IM should only be changed where the benefits outweigh the costs, but this is not a materiality threshold and the benefit/cost analysis is likely to be subjective. We submit that a materiality threshold is needed.

[2] Orion, "Submission on the IM review", 21 August 2015, para 7.

13 Our previous submission also considered that the core economic principles underpinning the IMs (e.g. the expectation of earning at least a normal return) needed to be re-stated and any change to an IM needed to be consistent with these core economic principles. Some aspects of the draft decision remain consistent with these core economic principles – for example the ability to leave stranded assets in the RAB until they depreciate remains unchanged, which we support. However, Orion is concerned about the risk that the core economic principles are being watered down or avoided. The two clearest examples are:

13.1 The strong Commission view that some portion of losses following a catastrophic event should be borne by the supplier,[3] which contravenes the real FCM principle (as suppliers know, ex ante, that if a catastrophic event occurs they will not recover some losses). As the probability of a catastrophic event is non-zero for all suppliers, on an ex ante basis they will expect a small probability of making a loss.

13.2 The indication in Topic paper 3 on emerging technologies that suppliers may in the future be unable to recover the full cost of their investments depending on the scale and pace of technology change.[4]

14 Both of these statements undermine the *ex-ante* expectation of achieving real FCM and compromise incentives to invest in regulated infrastructure, contrary to the Part 4, s52A Purpose Statement.

The future impact of emerging technologies in the energy sector

Benefits of emerging technology investments by EDBs

15 As we discussed in our previous submission on this topic, the technologies that are emerging in the electricity sector are creating opportunities to deliver real and material benefits to consumers in terms of improved resilience, reliability and efficiency.[5] The use of emerging technologies is also likely to provide opportunities for EDBs to deliver network services more cheaply, e.g. by deferring capital expenditure.

16 We consider that these advantages are best achieved through co-ordination of the technologies. Co-ordination will ensure they are operated together to manage load across a portion of a network. EDBs are best placed to undertake this co-ordination. Consumers on any network will be spread across a (growing) number of retailers, making it challenging for retailers to deliver a similar level of co-ordination.

17 We are currently investigating opportunities to support customers' use of batteries to smooth peaks on our network and thus avoid larger network augmentation costs. Any regulatory intervention that made these kinds of initiatives harder is likely to increase costs for consumers. Costs will be higher because either the emerging technology solution will not be progressed, where it may be a lower cost solution than that provided by standard

[3] Draft decision Topic paper 1 – Form of control and RAB indexation, para 126.

[4] Draft decision Topic paper 3 – The future impact of emerging technologies in the energy sector, para 75.

[5] Orion, Submission on emerging technology and the IM review, 4 February 2016.

technology, or because the emerging technology solution will be accompanied by additional administration and regulatory compliance costs.

Competition for emerging technology services

18 Some retailers have raised concerns about their ability to compete with EDBs in the provision of services using emerging technologies, especially batteries.[6]

19 We believe that it is far too early in the development of these technologies to even be confident that this problem does or will exist in the future, let alone identify the optimal solution. Regulating now would create material costs for all EDBs and consumers without any clear benefit, and also hamper beneficial research and development as discussed below.

Regulation of emerging technology and related activities

20 We also remain concerned that some parties are effectively arguing for ring-fencing of all EDBs' load management activities. We, like other EDBs, has been operating load control systems for many years, providing similar services to those that could be provided by batteries. Ring-fencing these services would be costly and inefficient.

21 We are happy to work with retailers or third parties in finding the best solution for delivering load management services where this will assist in delivering positive outcomes for consumers.

22 Ring-fencing or unbundling of battery / demand-side management services from electricity lines services is a policy question. We agree with the Commission that it would not be appropriate (or possible) for the Commission to impose market separation regulation under Part 4 in relation to this service.

23 We also agree with the Commission's interpretation of the definition of electricity lines services. We agree it is sensible to view assets and activities that are used to provide the regulated service as being part of the regulated service, even where they do not physically convey electricity by line. Taking a more narrow interpretation would exclude core activities like business support services, which are clearly part of the regulated service, from being recovered through lines charges.

Electricity Retailers Association of NZ proposal

24 The Electricity Retailers Association of New Zealand (ERANZ) has put forward an alternative proposal, which would require that domestic scale batteries (and other selected technology) would only be able to be included in regulatory asset bases if they met certain specified criteria.[7]

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[6] For example, Contact Energy, Submission on the Commerce Commission's Emerging technology pre-workshop paper, 4 February 2016.

[7] ERANZ, Submission on Emerging Technologies – Workshop and Pre-Workshop paper, 4 February 2016.

25 Where these criteria are not met, ERANZ proposes that the value of battery assets in the RAB should be set to zero. ERANZ's proposal would force EDBs to make any investments in battery technologies through an arm's-length related party, or EDBs could purchase the necessary services from third parties. ERANZ considered this would better promote competition in the domestic-scale batteries market. This approach would also apply to other emerging technologies.

26 We agree with the Commission that the proposal by ERANZ would deliver regulation that is not technology neutral. Orion considers that technology neutral regulation is preferred – it is least likely to avoid distortionary effects, and is more likely to be durable to changes in technology and also how certain technologies may be used.

27 Further, ERANZ's suggested criteria for determining whether assets should be, in effect, excluded from the RAB are numerous and subjective (e.g. "Is the new technology likely to have value beyond the regulated service?").[8] ERANZ does not make it clear what the threshold is for assessing particular investments against the criteria or whether any criteria should be given more or less weight. Such vague criteria are likely to fail to achieve the Purpose of Input Methodologies[9] ("to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services").

28 ERANZ also argues that the current IMs do not deliver a level playing field for parties to compete in providing emerging technologies. We do not consider that it is an objective for Part 4 to deliver a 'level playing field' in particular technologies that may be competitive. Also, Orion agrees with the Commission that other parties have advantages that EDBs do not have (e.g. retailers have better access to customers). If the Commission was required to deliver a level playing field we assume the Commission would need to find a way of neutralising any advantage retailers may receive due to their access to customers, as well as any other advantages held by other potential competitors.

Electricity Authority emerging technology letter

29 Carl Hansen, Chief Executive of the Authority, has written to Sue Begg, Deputy Chair of the Commission to register concerns about the implications of regulatory treatment of cash flows for emerging technology. The Authority raises similar concerns to retailers regarding the competition impacts of EDB investments in emerging technologies.

30 We do not agree with the Authority's letter. The Authority's concern appears to be that EDBs will leverage their regulated business to make investments in unregulated business activities, which other parties such as retailers will be unable to compete with. The Authority has not provided any evidence of anti-competitive behaviour and we note that section 52T(3) of the Act requires the Commission to ensure that the IMs do not unduly deter investment by EDBs in non-regulated services.

[8] Ibid, page 19.

[9] Section 52R.

31 Orion considers that the benefits from EDBs investing in emerging technology outlined above (potentially providing better services at lower cost as well as supporting the development of markets using the new technologies) outweigh any perceived risks outlined by the Authority.

Cost of capital

32 Orion supports the submission by the ENA on Topic Paper 4 – cost of capital issues. Our comments on areas of particular interest to us on this topic are summarised briefly below.

CPP WACC

33 We support the proposal to fully align CPP WACCs with the DPP WACCs. This will reduce potential perverse incentives and disincentives for CPPs. Importantly it also removes a timing constraint in the period leading up to making a CPP application, as the relevant WACC will be known well in advance, in all years except the last year of a DPP regulatory period. In this instance we recommend that the prevailing DPP WACC is used in the CPP application, and adjusted during the assessment period once known, and prior to a CPP determination being made.

34 We consider that the proposed implementation, to reopen the CPP price path from the date a new DPP WACC comes into effect, is both sensible and workable. It should also be relatively straightforward to implement.

35 We note however that all elements of the CPP price path which use the WACC will need to be reopened, not just the return on capital and revaluation building blocks as proposed. In particular, the cost of debt in the regulatory tax building block will also need to be reopened.

Cost of debt parameters

36 We agree that the proposed extension of the time period (to 3 months) for determining the average of bond rates for estimating the risk-free rate and debt premium is an improvement on the current method. However we do not consider that this proposed amendment goes far enough to address the volatility in the debt parameters which has been experienced in the regulatory WACC decisions since the IMs were first determined in 2010.

37 As previously submitted, we support the use of trailing averages, rather than prevailing yields for determining these debt parameters. This will:

37.1 make WACC estimates more stable over time, therefore increasing regulatory certainty;

37.2 more appropriately reflect the time period over which businesses arrange financing and hence improve the basis for estimating realistic and achievable costs of debt for EDBs; and

37.3 mirror changes in the regulatory approach for establishing cost of debt estimates which have occurred in Australia and the United Kingdom since the IMs were determined in 2010.

38 In addition, we submit that bonds of a longer term than five years should be used to estimate the risk-free rate and debt premium, in order to reduce volatility and increase certainty. We consider that ten years is appropriate which would better reflect and compensate suppliers for efficiently issued longer-term debt.

39 This approach would also avoid the need to use the term credit spread different allowance (TCSDA), which compensates for the difference in actual and assumed bond tenors.

40 As previously submitted, we also recommend that suppliers are compensated for the efficient and prudent costs of maintaining stand-by bank facilities. Contrary to statements in Topic Paper 4, and in the Commission's 2010 IM Reasons Paper, suppliers are not currently compensated for these costs. The cost of debt calculated using the IM method only reflects the cost of debt which is actually drawn down, and excludes the costs of standby facilities.

Standard error

41 Topic paper 4 suggests removing the standard error formula published in the IMs. The Commission has subsequently suggested that the relevant formulae should be included in the Commission's workbook on WACC. We consider that this is an appropriate and workable solution, and support the publication of the formula because it maintains transparency as to how the WACC parameters are derived.

Impact of form of control decision

42 We support the draft decision to retain the asset beta estimate for EDBs which is derived from the comparator sample, with no adjustment for the form of control decision. We support the view that a reasonable sample size is required for this purpose, and therefore it is not appropriate to reduce the sample on the basis of regulatory differences. We also consider that it is useful to maintain as much stability in the sample as possible over time. We note that the sample also includes gas, electricity and duel fuel (gas/electricity) businesses.

43 Accordingly, given the comparator sample to be applied, and the lack of compelling evidence supporting any adjustments to the asset beta to reflect different levels of systematic risk associated with the form of control, Orion a supports the retention of the 0.34 asset beta for EDBs, as proposed in the draft decision.

Specification of price, DPP reopeners and IRIS

Form of control

44 We support the draft decision to apply a 'pure' revenue cap to EDBs.

45 We also consider that the revenue cap would be more effective and more likely to deliver beneficial outcomes for consumers if there was a mechanism that ensured EDBs had

incentives to connect new large customers to the network. This could be in the form of a simple reopener or a recoverable cost relating to the costs of connecting a large and unexpected new customer or group of new customers.

Benefits of a revenue cap

46 We agree that a revenue cap will remove the risk of EDBs earning more or less than their revenue requirement due to errors in volume forecasts by the Commission.

47 We also agree a revenue cap will make it easier for EDBs to make changes to their prices to deliver efficient pricing (because the compliance risk and revenue recovery risk from embarking on price restructures will be significantly reduced under a revenue cap).

Revenue cap wash-ups

48 We consider that the wash-ups methodology proposed in the draft decision could be simplified.

Annual wash-up of differences

49 We support an annual wash-up of the difference between the revenue received and the allowable revenue. This is the core feature of a pure revenue cap and should be the only wash-up necessary. We do not support more than one wash-up being applied – the effect of the various wash-ups being proposed in the draft decision can, we believe, be combined.

Cap on wash-up amount

50 We do not support the introduction of a "cap on wash-up amount" which is intended to make suppliers bear a portion of the loss resulting from a major change in demand. This approach is based on a decision on Orion's CPP that, in the context of a price cap, consumers and suppliers should share the risk of catastrophic events.

51 We do not consider that this decision can simply be carried across to a different form of control for the reasons summarised below:

51.1 There are examples in both the CPP final reasons paper and the draft decisions paper where the Commission considers that Orion should not be compensated for past lower-than-forecast revenues, due to the earthquakes, because we were subject to a price cap (rather than revenue cap). A price cap, by its nature meant we retained the benefit of an increase in demand but had to bear "demand risk by default". [10, 11]

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[10] Commerce Commission – Setting the customized price-quality path for Orion New Zealand Limited Final reasons paper:
B7 However, we have not compensated Orion for past lower-than-forecast revenues due to the earthquakes. No claw-back has been provided for lower-than-forecast revenues because:
B7.1 **the fact that Orion is subject to price cap (rather than revenue cap) regulation means that it bears demand risk by default** (emphasis added)

[11] Commerce Commission – Setting the customized price-quality path for Orion New Zealand Limited Draft decision paper: B64.1
"Orion was operating under a price cap, not a revenue cap. A price cap implies that demand risk is borne by suppliers." (emphasis added)

51.2 Given the proposed move to a revenue cap, where the Commission notes "In this paper, we refer to a revenue cap which effectively guarantees allowable revenue as a 'pure' revenue cap."[12] It is inappropriate and inconsistent to apply a "cap".

51.3 The Commission considered in both its draft CPP decision and the final CPP reasons paper the impact of the Canterbury earthquakes from the perspective of a diversified investor. In the final reasons paper it noted at Paragraph B73:

> *In the draft decision we explained that the impact on demand of depopulation resulting from a catastrophic event is not necessarily asymmetric because:[303]*
>
> *B73.1 the probability of a region gaining population as a result of a catastrophic event elsewhere will be similar to the risk of losing population due to a local event; and*
>
> *B73.2 by diversifying across different regions, an investor is able to costlessly insure itself against relocation risk.*
> *(footnote 303-Commerce Commission "Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited: Draft Decision" (14 August 2103), paragraphs C96-C105)*

We submit that the proposed change in form of control to a revenue cap means that loss of revenue in one region will **not** be compensated by a rise in revenue in another region. Suppliers diversifying across regions will not be compensated for loss of revenue as a result of an increase in other areas. Therefore, applying a "cap on the wash-up amount would lead to smaller than normal returns across the entire industry (contrary to the objectives of Part 4). The Commission's proposal will impose an asymmetric approach; suppliers will, unlike a price cap bear demand risk but not achieve benefits from growth.

51.4 The Commission estimated that our revenue losses at 7% were within normal bounds[13]. Therefore under a revenue cap we would expect to be able to recover such normal losses.

51.5 The Commission has, since the Orion CPP decision, reduced the WACC from the 75th percentile to the 67th percentile, reducing the compensation for catastrophic events that was claimed to exist.[14] The cap on wash-up amount places further financial pressures on suppliers.

51.6 The Commission's proposal, is that for EDB's, it is ex ante providing an expectation of a real return (FCM) under a revenue path. A cap on wash-up amounts where some portion of losses following a catastrophic event is borne by the supplier is inconsistent with this.

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[12] Commerce Commission – Input methodologies review draft decisions - Topic 1 – paragraph 13 **"In this paper, we refer to a revenue cap which effectively guarantees allowable revenue as a 'pure' revenue cap."** (emphasis added)

[13] Commerce Commission – Setting the customized price-quality path for Orion New Zealand Limited Draft decision paper: C121.1 We estimate that revenues were approximately 7% lower than forecast during the claw-back period. Reduced demand of 7% does not obviously lie outside a normal range (particularly if we were to adjust for demand that shifted to other areas).

[14] Commerce Commission – Setting the customized price-quality path for Orion New Zealand Limited Final reasons paper: C5.2 The practical effect of using the 75th percentile WACC (determined under the IMs) is to provide a buffer against the financial impact of catastrophic events.

51.7 The Commission's approach could incentivise EDB's to concentrate resources on a CPP application following a catastrophic event to minimise the timeframe that suppliers are exposed to reduced revenue at a time when resources are constrained.

51.8 We also note that the Commission is not proposing a "cap on wash-up amount" to be applied in respect of the Transpower revenue cap. We consider this is the correct approach and the Commission should be adopting the same approach in respect of EDBs. Clearly different approaches cannot be consistent with Part 4.

Wash-ups to smooth price changes

52 We are not opposed to mechanisms to smooth prices over time, but we are not sure any will be necessary. The price cap regime has seen some large price swings that have been managed successfully.

53 We also submit that two separate price smoothing wash-ups, one based on the price change and one based on a percentage of net allowable revenue, are not needed. The two seem to double up and deliver much the same outcome. They are likely to cause confusion if implemented together, and therefore add undue complexity to the regulatory regime.

Electricity Authority form of control letter

54 The Authority wrote to the Commission on 30 May setting out concerns about the incentives that might be created if the form of control for EDBs changed to a revenue cap.

55 Contrary to the Authority, we believe introducing a revenue cap would improve EDBs' incentives to adopt efficient prices.

56 As discussed previously, introducing a revenue cap would mean that EDBs risks of breaching the DPP price path or of under-recovering revenues as a result of restructuring prices are reduced. This significantly reduces one of the more significant barriers to distribution pricing reform.

57 The Authority's concerns are drawn from the theory of efficient pricing we are aware that we need to continually review and refine our prices, as we have done for many years, to ensure we are providing efficient pricing signals to our customers, and adapting to changing demand patterns and supply options. A move to a revenue cap will not change this.

58 The Authority appears to misunderstand the nature of the quantity forecasting risk the Commission is seeking to address. The risk is not that EDBs have variable volumes of sales and the challenge of forecasting this variation. As the Commission appreciates, the quantity forecasting risk is a result of the way the price path is set and the risk that the Commission's volume forecasts are inaccurate and thus EDBs earn more or less than their revenue requirement as a result.

59 Moving to a revenue cap means EDBs will have a greater expectation ex ante of being able to recover their regulated revenue requirement than under a weighted average price cap, as one key source of uncertainty, which is not able to be managed by EDBs, is removed.

This is likely to better promote incentives to invest while limiting the ability of EDBs to earn excessive profits.

60 The Authority raises a concern that a revenue cap could drive EDBs to apply extremely high prices for price sensitive customers or assets. We disagree. It would be very difficult for a distributor to target its pricing to the extent required to deliver such an outcome. More importantly, it would be very unpopular with the consumers whose preferences we take very seriously when setting our pricing structures. It would also be inconsistent with the Authority's own distribution pricing principles.

61 The Authority states it may regulate or scrutinise distribution prices further if a revenue cap is applied to EDBs. This is a matter for the Authority, who will need to develop and consult on a proposal after consideration of the Authority's statutory objectives, and for the Authority's stakeholders, who will need to consider and respond to any proposal. We do not think a statement regarding the potential future actions of a different regulator should be a material factor in the Commission's decision on the form of control, particularly where there are no details available about the proposed regulatory intervention.

62 We agree with the assessment by the AER that a weighted average price cap form of control will not have a greater influence on the development and implementation of more efficient distribution pricing structures, than a revenue cap. Consumer response, the availability of metering and support systems, education, retailer response and the degree of complexity are all factors which are expected to have more impact on the development and uptake of new distribution pricing structures, than the form of control.

63 As stated above the incentives on EDBs to embark on pricing reform are improved by removing the compliance risk and complexity inherent in the weighted average price cap.

Other specification of price IM amendments

64 We support ways to improve the interplay between CPPs and DPPs, in particular to provide more opportunities for DPPs to address business specific circumstances, thus reducing the circumstances where a full CPP application will be required.

65 In particular we support moving the quality standard only CPP option from the CPP IM, to a DPP reopener, noting that a full CPP proposal may include a quality standard variation proposal. We agree with this proposal, subject to the transitional issue noted below.

66 The draft decisions propose the following additional changes to the specification of price IM:

66.1 Enable new pass-through costs to be specified in a DPP Determination and provide that these can be any type of cost, not just levies. This is helpful as it may be necessary to create a new pass-through cost when a DPP is set and this need may extend to costs other than levies. We agree with this proposal.

66.2 Create a new recoverable cost for reopening a CPP relating to urgent projects. We agree with this proposal and support a similar reopener being applied to DPPs.

66.3 Remove the energy efficiency and demand-side management allowance as the disincentive this is designed to address will no longer apply under a revenue cap. We agree with this proposal, but only if the form of control changes to a revenue cap.

67 The draft decisions propose the following additional changes to the DPP reconsideration IM:

67.1 Expanding the error reopener to include cases where data was applied incorrectly. We agree with this proposal provided the ability to initiate a reopener is restricted to the Commission and suppliers.

67.2 Create a price-quality path reopener to address any problems caused by a major transaction. This recognises that transactions can create multiple regulatory compliance issues which are not always foreseeable. A price path reopener is a more pragmatic solution than attempting to develop comprehensive major transaction provisions in advance to deal with every possible scenario. We agree with this proposal.

67.3 Create a reopener to apply the next closest alternative (NCA) provision where it requires a change to a price-quality path. We do not agree with this proposal, as discussed in paragraph 105 to 114 below.

67.4 As noted in the cost of capital section, above we support the proposal to align the CPP and DPP WACC rates for suppliers on a CPP. This change will require the Commission to create a reopener for a CPP where the DPP WACC is amended. We support the introduction of a reopener and expect that it would be applied mechanically for the sole purpose of taking account of the change in WACC.

67.5 Change the reopener materiality threshold so the 1% materiality threshold would only apply to errors in allowable revenue rather than errors that might affect other aspects of the price-quality path. The materiality threshold for reopening a quality standard would be stated in the relevant DPP Determination. We support this proposal as applying a 1% of revenue materiality threshold to the quality standard is unlikely to be workable.

68 We consider that the ability to trigger a reopener should be limited to EDBs and the Commission. It should not be open to third parties to initiate reopeners.

Quality-only reopener: transitional issue

69 A transitional issue emerges resulting from the replacement of the CPP quality reopener with a DPP quality reopener. As the change in IM's cannot apply to an existing DPP determination the DPP quality reopener will not be effective until 2020 while the CPP quality only option will have been removed leaving the only option as a full CPP. We suggest that the CPP quality only option should be retained until 31 March 2019[15].

[15] CPP applications are not permitted in the period between 1 Apr 2019 and 31 Mar 2020

Incremental Rolling Incentive Scheme

IRIS does apply to Orion in 2020

70 We are concerned that the draft decisions do not correctly reflect the status of our current asymmetric CPP IRIS. The Report on the IM review states that:

> "Orion will have one-year of the DPP regulatory period remaining once it transitions off its CPP. However, as confirmed in our recent paper on the Orion transition to the DPP, the IMs 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."[16]

71 We consider that the above comment is broadly drafted and could be inappropriately interpreted to mean that Orion's asymmetric IRIS that applies only to opex does not apply.

72 The Commission has, in response to our question on this issue[17], clarified its position in the draft report on Orion New Zealand's transition to the 2015-2020 default price path. The Commission states:

> *2.3 Also, in terms of how the Incremental Rolling Incentive Scheme (IRIS) applies to Orion under the 2015-2020 DPP, our draft decision is that:*
>
> *2.3.1 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);*
>
> *2.3.2 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; and*
>
> *2.3.3 Finally, whether Orion transitions to the 2015-2020 DPP or starts a new CPP from 2019, Orion is allowed to recover the IRIS costs that are applicable under its current CPP.*[18]

73 We agree with the above draft decision and consider that this indicates we are permitted to include IRIS incentive recoverable costs when setting prices in the five year period immediately following the end of the CPP (i.e. in the year ending 31 March 2020), irrespective of whether we transition to the DPP, or a new CPP is determined, otherwise our current IRIS would have no effect. If the Commission has a different view, we request discussions on this point.

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[16] Report on the IM review, 22 June 2016, paragraph 452.

[17] Orion's submission on Orion's transition to the 2015-2020 DPP

[18] Paragraph 2.3 Orion's transition to the 2015-2020 DPP Draft report 1 July 2016

IRIS IM amendments

74 The draft decisions proposes to change the IRIS IM to spreading the value of 'second-year adjustment' over the regulatory period. This is intended to avoid price shock risk associated with potentially large one-off adjustments that the current IRIS may create. Orion agrees with this proposal.

CPP requirements

Reducing cost and complexity

75 We support the Commission's intent to reduce the costs and complexity of CPPs by revising certain aspects of the CPP IMs and providing more guidance about the Commission's expectations for CPP applications.

76 In particular we support the proposals to:

76.1 Remove duplication between ID requirements and CPP information requirements, recognising the role that AMPs, in particular, can play in meeting CPP information requirements. In this respect we note that we expect that the 'alternative methods with equivalent affect' provisions will also allow EDBs to use their own expenditure categories if desired, which may have benefits for some EDBs whose planning information is prepared in a different format to that incorporated in the ID requirements.

76.2 Provide more guidance about the Commission's expectations of evidence to support customer consultation on the CPP proposal and the ability of an EDB to deliver the proposed CPP expenditure plan.

76.3 Reduce the level of detail required in CPP applications including information about related party transactions, capital contributions, asset categorisation and service categorisation.

77 We note that the drafting of Schedule D does not necessarily achieve these outcomes as well as it could. For example while D12(2) specifies that related party information can be described at an aggregate level, D12(3) then requires that for all of the related party services described in D12(2), the CPP proposal must include the following information:

77.1 Provide a description of tendering processes for each service

77.2 Identify all relevant documents used to tender for the provision of each service

77.3 Explain the contract arrangements for each service

77.4 Explain the competitive nature each of the services provided.

78 In addition D12(4) requires methodologies, consultants reports, assumptions used in determining contract prices for each contract identified in response to D12(3)(c).

79 We note that the period covered by these information requirements is the 5 year current period, plus the 2 year assessment period, plus the 3-5 year CPP regulatory period.

80 We therefore submit that this drafting has not achieved the stated objective of reducing cost and complexity, and retains excessive information demands in respect of related party information. Our own CPP experience was that we were unable to collate the specified material for every related party transaction across the 12 year period specified in the CPP IMs in a cost effective manner. We note that a sample approach was sufficient for the Commission's assessment of our CPP application.

81 We have not commented on the detailed drafting of the proposed changes to the CPP IMs in this submission. However we note that the draft templates and schedules issued with the draft decisions currently contain errors, introduce undefined terms and create additional ambiguity. Therefore we encourage the Commission to fully consider the detailed comments in the ENA's submission on the Draft Determinations and to undertake a comprehensive review of all of the proposed changes to the CPP IMs to address these issues.

Verification

82 It is proposed that the role of the verifier is revised, and some changes to Schedule G (Terms of Reference for Verifiers) are introduced as a result. In principle we support refinements to the verifier's terms of reference which:

82.1 Extend the scope of the verification to include customer consultation, quality standard variations and contingent projects

82.2 Exclude non-standard depreciation from the scope of verification

82.3 Allow more flexibility in the number of identified projects and programmes to be assessed by the verifier. However we continue to be concerned that the identified projects/programme process will require applicants to prepare detailed evidence supporting all projects and programmes in advance, due to the time constraints in preparing a CPP. The indicative timetable included in Topic Paper 2 reinforces this view.

83 One way to provide more certainty for the applicant, and enable them to prepare as much detailed information for the verifier in advance, is for the largest projects and programmes to be retained as part of the verifier's selection

84 In refining Schedule G, we consider that the drafting has unhelpfully introduced a number of terms and concepts which are inconsistent with the remainder of the CPP IMs, and thus if implemented, will increase cost and complexity of CPPs. In particular the new Schedule G:

84.1 Introduces assessment criteria which are not consistent with the assessment criteria for a CPP (as set out in Part 5, Subpart 2, clause 5.2.1), (eg: G2(1)(b) "*assessing the extent to which the CPP applicant's policies allow the EDB to provide services on an efficient basis and that meet the general needs and expectations of consumers")*

84.2 Extends beyond the scope of the verification role by using terminology which is too general (eg: G2(1)(d) "*assessing whether the CPP applicant has provided complete and sufficient information in its intended CPP proposal")*

84.3 Introduces terminology which is inconsistent with similar terminology in the Act or elsewhere in the IMs (eg: G4(2)(a) *“the best interests of consumers over the long term”* and G4(2)()b) *“the Commission’s ability to effectively review the* ***CPP applicant’s expenditure objective****”*

84.4 Fails to recognise other relevant aspects of the CPP information requirements (eg: Subpart 4, Section 1, clause 5.4.2 Reasons for the proposal and clause 5.4.3 Information regarding the priority of the proposal).

85 We submit that the proposed sections G2, G3 and G4 of Schedule G require a substantial rewrite to address these issues, including, but not limited to, addressing the examples noted above. The objective of the redrafting should be to tighten up the clauses, remove duplication, and better align with wider IMs in order to reduce cost and complexity of CPPs.

86 We do not support the intention for an applicant to provide the Commission with a summary of its CPP proposal prior to engaging a verifier, and an updated summary prior to the verifier’s draft report. Topic Paper 2 describes the main intent of this summary report is to allow the Commission to plan its assessment of a CPP application.

87 We believe that this proposal will greatly increase the burden on the CPP applicant during the period when the CPP activity is most intense for them. We submit that the proposed summary report is unnecessary, distracting and potentially misleading. This is because:

87.1 During this period the applicant is developing and testing its proposal, including internally, with consumers, directors, the verifier and auditors. It must be able to do this unencumbered by scrutiny by the Commission at this stage in the process. The Commission’s exposure to the CPP proposal, as set out in the IMs, commences, if and when the application is submitted

87.2 The Commission already has access to forecast expenditure, demand and service standards for the EDB and supporting explanations through information disclosures in the period leading up to a CPP proposal being submitted

87.3 The Commission will have access to public consultation material on the CPP proposal – including investment alternatives and price and quality impacts, prior to the CPP being submitted

87.4 The Commission will have opportunities for discussion with the applicant prior to the CPP being submitted

87.5 The verifier is tasked with reviewing the CPP application and advising the Commission where to focus its review efforts. This is intended to assist the Commission to manage its resourcing requirements. The Commission is able to retain the verifier to assist with its assessment of the CPP proposal once submitted

87.6 The Act already limits the number of CPP proposals the Commission must consider at any one time. The application windows also place constraints on when CPP applications are able to be made, to ensure there is sufficient time for assessment of CPPs before determinations are made for the next pricing year.

88 Further, we consider that the summary report requirement contradicts the proposed refinements to the verifier's communications protocol. These are intended to provide more certainty to applicants that they are able to engage openly with the verifier during the pre-application phase, with the knowledge that the Commission will not view draft material. We support this new communication protocol.

Asset valuation

RAB indexation

89 Any form of indexation also requires a forecast of the index to be (appropriately) treated as expected revaluation gains for the purposes of pricing. Forecasts can and will differ from outcomes and so indexation creates risks either that consumers will be overcharged or that EDBs will not receive sufficient funds to cover their debt costs, which could in theory result in what Dr Lally terms the bankruptcy risk).

90 Provided that the treatment of revaluations and the form of the WACC are chosen to be consistent with the method of indexation, then the *ex ante* NPV of indexation is the same as that for an un-indexed approach. The Commission should therefore be indifferent between the two methods. However, there are practical reasons why consumers and EDBs *would not be indifferent* between the two approaches.

90.1 By pushing cost recovery further out into the future in an environment of technology change that creates potential for consumers to materially reduce their demand, an indexed approach exposes future consumers to a risk that, as some consumers reduce demand or move to a full self-supply arrangement, remaining consumers could face unsustainable charges. This would imply rising prices at a time of falling demand, something which is clearly not sustainable.

90.2 This type of risk may also cause EDBs to be more reluctant to invest under an indexed approach, which is also unlikely to be in the long-term interest of consumers. As a result an un-indexed approach is superior in promoting the purpose of the Act.

91 This approach is consistent with the Commissions views on the reduction in asset lives of up to 15% where the asset is at risk of stranding.

92 We agree with the concerns raised by the ENA in relation to the issue that under an indexed approach EDBs earn a real return but are required to make debt repayments in nominal terms and thus revenues will not move in line with debt repayment obligations unless the supporting inflation forecasts are perfectly accurate. We support the ENA submission on this topic

Asset valuation IM changes

93 The draft decisions propose the following changes to the asset valuation IM:

93.1 Enabling EDBs to apply for a reduction in asset lives of up to 15% where the asset is at risk of stranding. This is intended to be a precautionary measure to reduce the risk of much higher per-customer prices in future should emerging technologies reduce demand for regulated services. We support this but request the Commission provide further guidance (not necessarily in the IMs) on the process and basis for assessing these claims. We also consider that there should be scope to apply this accelerated depreciation to the same asset more than once (i.e. reduce the asset's life by up to 15% at two different price resets) as the risk of asset stranding could increase over time.

93.2 Clarify the treatment of finance lease payments where the finance lease forms part of the RAB. While this is reasonable in principle, as discussed in the ENA submission, the drafting of the determination does not successfully implement this change.

93.3 Expand the definition of capital contributions to include money received in respect of asset acquisitions. We agree with this proposal, which is a useful clarification.

93.4 Clarify that the calculation of financing costs that can be capitalised on a commissioned asset is based on a value of works under construction that is net of capital contributions. We agree with this proposal.

93.5 Change references from 'related company' to 'related party' – this is essentially an error correction as the correct term is related party. We agree with this proposal.

93.6 Require EDBs to use their GAAP cost of financing capped at the EDB's New Zealand dollar weighted average cost of borrowing, when calculating the cost of financing for assets under construction. Orion agrees with this proposal, which is intended to ensure the IMs more closely reflect the actual cost of financing of each EDB.

93.7 The asset life of non-system fixed assets is determined by applying the asset life used under GAAP. This is a more practicable option than asking an independent engineer to determine the life of a non-system fixed asset. We agree with this proposal.

93.8 Clarify that asset lives are not reset on the transfer of assets and that the value of an asset is adjusted for depreciation and revaluation applying in the year of the transfer. These clarifications will provide for assets' depreciation to be correctly applied. We agree with these proposals.

93.9 Remove a requirement for suppliers to spread depreciation for 'end of life' assets over the CPP regulatory period, which removes an unnecessary compliance complexity. We agree with this proposal.

Cost allocation

94 The draft decisions propose the following changes to the cost allocation IM:

94.1 Reducing the materiality threshold for applying ACAM from 20% to 10%. The Commission considers that the current threshold is too high and could permit costs to be allocated to regulated businesses to the extent of having a material effect on prices. We do not agree with this proposal for the reasons outlined in the ENA submission.

94.2 Requiring more disclosure of the rationale for choosing proxy allocators. Regulated suppliers will need to explain any use of proxy allocators, rather than causal allocators, and to justify the use of the proxy allocator(s) chosen. This is intended to address concerns that proxy allocators may be allocating too many costs to the regulated businesses. We agree with this proposal for the reasons outlined in the ENA submission.

94.3 Clarify that distributions to customers are not operating costs. We agree with this proposal, which is consistent with our current interpretation of the IMs.

94.4 Clarify that intercompany revenue is not included in revenue for the purpose of assessing the ACAM revenue threshold. We agree with this proposal, which is consistent with our current interpretation of the IMs.

Related party transactions

95 The draft decisions paper puts forward a holding position on the rules regarding related party transactions, stating that these will be reviewed on a longer timeframe than the other IMs. This delay is partly due to the complexity of the issue and partly due to the interaction between IM related party rules and the related party rules in the information disclosure requirements.

96 Given the complexity of the topic, we support a longer timeframe to review the related party transactions. Our related party transactions with Connetics Limited are a major part of our business and it is important the regulations that apply to these transactions are appropriate and workable.

97 The draft decisions paper also seeks information about the reasons for the related party structures that EDBs have in place. Our reason is that it provides a long term benefit to consumers.

98 The long term customer benefits are:

98.1 Lower prices as a result of an efficient competitive tender process. Our policy is to grant contracts to the lowest conforming price tenders.

98.2 ensures there is a provider with sufficient scale to meet our requirements particularly in emergencies.

99 The draft decisions paper also notes that the value of related party transactions across the industry has increased since 2012, and faster than the value of industry operating costs. The value of our related party transaction expenditure has in fact fallen between 2012 and

2015, which is a result of unusually high expenditure in 2012 as part of our response to the Canterbury earthquakes and increasing competition in our market for electrical contracting services. The inclusion of Orion data within this analysis might not be appropriate given our unusual circumstances.

Next closest alternative

100 The draft decision proposes a new way of applying alternative approaches where IMs become unworkable. This is referred to as the next closest alternative (**NCA**) provision.

101 The intention is that where an IM becomes unworkable (e.g. an IM may reference external information that ceases to be available) the Commission would not need to go through the IM amendment process but instead could identify or develop the next closest alternative and then apply that. This may or may not have an effect on price path outcomes and may or may not be subject to consultation.

102 We appreciate the Commission is trying to establish a reasonably quick and cost-effective method of making what will be fairly minor amendments to the IMs. However, the proposal may not be appropriate or consistent with the Part 4 framework.

103 Sections 52X and 52V of the Commerce Act set out a process for amending the IMs. This process has been applied to make some fairly minor corrections to the IMs (e.g. correcting the definition of notional deductible interest). The Act does not appear to provide for an urgent amendment process where the IMs become unworkable. This may be an oversight in the Act but we are not sure if this amendment process can then be created in the IMs themselves.

104 We submit the status of any NCA alternative could be clarified. Paragraph 68 of the Report on the IM review notes they will be published outside the IMs. It seems the text of the IMs will remain unchanged until a future amendment process. It is difficult to be sure why the NCA would be deemed to override the IMs. The proposal appears to be a somewhat more formal version of the Information Disclosure issues register, which, through "clarifications", effectively provided amendments to the Information Disclosure Determinations until those determinations could be amended.

105 Orion is concerned that the proposal may undermine certainty. The draft decision states that certainty will be provided as the policy intent will not change, but it may not always be possible for the NCA to have a closely equivalent effect.

106 The Report on the IM review states that "in rare circumstances it might not be possible to develop an alternative approach that does not require a reconsideration of a current price-quality path." It is difficult to conceive of circumstances where the unworkability of an IM would require a price-quality path to be reopened. The price path is set and is then applied for the following five years. Any problems with inputs to the price-quality decisions should not make those decisions unworkable. It seems this may be more likely to relate to a finding that a particular reopener or compliance requirement is unworkable but required by the IMs. We consider that it should be specified that the NCA provision will not deliver

changes to the allowable revenues or quality standards, but only to the mechanics of the price-quality path.

107 If this proposal is progressed we suggest it is time limited – urgent amendments can be made this way but only until such time as the Commission can go through the standard IM amendment process. This would be consistent with the process applied by the Authority when making urgent amendments to the Electricity Industry Participation Code – the Authority can make the amendments urgently but then must consult on them within 9 months.

108 We also think that consultation on any NCA should be required, rather than subject to the Commission's discretion.

109 The draft decision includes a process for suppliers to request a NCA. This process seems somewhat onerous; the suppliers are required to identify the problem, develop the NCA, explain the effect of the NCA and 'certify' the supporting information. In some circumstances suppliers may be able to do this but it may also be that the Commission will be best placed to develop a NCA. An option should be available for suppliers to simply identify a problem and request the Commission consider if there is a suitable NCA.

Treatment of taxation

110 The draft decisions propose the following changes to the treatment of taxation IM:

110.1 Provide that the information disclosure and CPP IM calculations for closing deferred tax include an adjustment for asset disposals. This is a necessary step in the roll-forward of the deferred tax balance. We agree with this proposal.

110.2 Clarify the tax effect of capital contributions on asset acquisitions. We agree with this proposal.

Concluding remarks

111 Thank you for the opportunity to make this submission. We do not consider that any part of this submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely

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