1 June 2012

Regulation Branch
Commerce Commission
Wellington

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

SUBMISSION ON ELECTRICITY AND GAS INPUT METHODOLOGY DETERMINATION AMENDMENTS 2012

1. Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the "Electricity and Gas Input Methodology Determination Amendments 2012": Consultation Paper (the **paper**) released by the Commission on 11 May 2012.

General comments

2. Orion's submission should be read in conjunction with (and is intended to be complementary to) the submission filed by the Electricity Networks Association (ENA).

3. Orion is supportive of information disclosure and we recognise that the Commission has obligations in this respect under the Act and that information disclosure has a specific purpose under the Act.

4. We reiterate our general concern with the Commission's information disclosure requirements that the amount of detail that the Commission is requiring exceeds the requirement to ensure that sufficient information is readily available to interested parties (including the Commission) to assess whether the purpose of Part 4 is being met.

5. More specifically we consider that the current proposal is very similar to the Commission's previous proposal outlined in the Commission's 16 January 2012 paper. As this paper acknowledges[1], this earlier proposal was opposed by the ENA (representing 29 EDBs) and several other submitters who raised various concerns about the proposal. The ENA submission suggested an alternate approach including

[1] Paragraphs 50 to 53

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the greater use of qualitative disclosure which the Commission has rejected[2] without providing any evidence to support its conclusion.

6. In our submission[3] responding to the January 2012 paper we raised a number of issues that we consider the Commission has not addressed and which remain relevant to the current proposal:

"We are concerned that a possible consequence of this proposal is that we might eventually elect to sell our interest in Connetics to simplify all of our regulatory arrangements. However, the considerable risk that we would face by doing so is that the purchaser could in turn elect to move out of part or all of the lines of business which currently support Orion, and even choose to leave the Canterbury region. Further, we could certainly lose our ability to control the availability and quality of contracting resource on our network. Owning part of Connetics increases the chance that Connetics will be prepared to make investment in staff, materials and equipment that are specific to Orion contracts. It will be less concerned that Orion would take advantage of this specific investment by insisting on a price that does not cover the cost of the investment.

In light of our own circumstances and experiences we turn to the Commission's proposals.

The Commission has proposed that an EDB should be allowed to include the actual price at which it purchased the goods or services from a related party transaction in its information disclosures:

- *where the related party makes at least 75 per cent of its sales to unrelated parties and the prices charged to the regulated supplier are demonstrably the same as those charged to unrelated parties;*
- *where the services in question had previously been outsourced and the regulated supplier can demonstrate that the cost of supply from the related party was the same or less than the costs incurred under the previous outsourced arrangement;*
- *where the value of all transactions with that related party is less than one per cent of the regulated supplier's total revenue from the regulated service for that year and the total value of all related party transactions is less than five per cent of the regulated supplier's total revenue from the regulated service; and*
- *where an open tender has been used and the directors can certify that the tender was open, that it was run to ensure that there were credible competing tenders, and the lowest qualifying tender was selected.*

We consider that these rules are overly prescriptive, poorly defined and extremely tight, and believe that as written despite our tendering model we might fail to "fit" within the Commission's proposed categories.

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[2] Paragraphs 31 to 33

[3] Orion New Zealand Limited, "Submission on information disclosure requirements for electricity distribution businesses: draft determination and draft reasons paper", 9 March 2012.

To take them in turn:

- *where the related party makes at least 75 per cent of its sales to unrelated parties*… the tender prices we receive from contractors are a mix of labour, materials and plant with different construction conditions and distances. How is it envisaged that prices charged to the regulated supplier can be **proven** to be *demonstrably the same* as those charged to unrelated parties? We also submit that the 75% threshold is overly tight and that a lower threshold at or below 50% should be the hurdle. It is also not clear why such a rule and such a threshold is needed to ensure that the market is workably competitive, as noted above, Connetics makes around 50% of its sales to unrelated parties.
- *where the services* [4] *in question had previously been outsourced…*this suggests that the services, once acquired externally, are now provided internally. Once brought back in-house, how and when would on-going verification be required to ensure that current costs and past costs are still in line, and also still represent like for like – that is, no increase or decrease in quantity and quality of service? Further, this would lead to a reduction in competitive pressure as the constant monitoring to an external market would cease.
- *where the value of all transactions with that related party is less than one per cent…* we consider that this 1% per related supplier and 5% for all related suppliers is far too narrow a band –. We submit that these very narrow bands should be extended. We recommend that the overall value of transactions be extended to at least 10% and that the per supplier transaction limit is removed. If not, some other approaches may be taken (eg, the inefficient restructuring of related parties to make them into multiple smaller entities).
- *where an open tender has been used…*what is meant by an "open tender"?. Are two parties, one related, one unrelated, sufficient to provide an "open tender"? Our experience has been that for our specialised work categories it is not sustainable in our market to have more than two tenderers. Also, as noted above, there might be circumstances where the lowest qualifying tender is not accepted for sound commercial reasons. It is not necessary for a tender to be 'open' in order for it to result in an outcome consistent with a workably competitive market. The Commission could analyse the circumstances of each block of tenders (that is those let to multiple parties etc), and perhaps tenders over time, in addition to the market circumstances to determine whether it would result in an outcome consistent with a workably competitive market.

We believe that some combination or hierarchy of the above rules, amended as we have suggested, might work in our circumstances and still provide some regulatory overview with respect to transfer pricing.

For example, if the Commission were to firstly ring-fence those related party transactions which were subject to an open tender process (subject to our concerns over definitions) and exclude them from the other categories, then the work we award Connetics on a non-

[4] Recognising that in this new context it is built assets rather than services that are being acquired.

tendered basis would be a very small component (less than 1%) of our overall regulated revenues, and it would be a small component (maybe 5% or so) of Connetics' overall revenue with respect to their total third party revenue."

Proposed changes to CPP IM's

7. We are also extremely concerned that the paper is proposing to make changes to Part 5 Subpart 3 which applies to customised price-quality paths. As the Commission is aware we are currently evaluating our options in relation to an application for a CPP under the catastrophic event criteria.

8. The paper has not proposed a draft of these proposed amendments, so we have no way of evaluating the impact of these proposed changes, however we find it most disconcerting that the basic ground rules set out in the IM's could possibly change in the middle of our application preparation. These and other regulatory changes make our environment extremely uncertain and difficult to work within.

9. In summary, we submit:

   9.1. that the cost of implementing a process as proposed outweighs the benefits which might be achieved, and

   9.2. that the old-style cost accounting approach proposed by the Commission is totally incompatible with an outsourcing model.

Endorsement of the ENA's recommended alternative approach

10. As indicated above we endorse the ENA's submission.

Concluding remarks

11. Thank you for the opportunity to make this submission. Orion does not consider that any part of this submission is confidential. If you have any questions please contact either Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz or Graeme Wilson (Management Accountant), DDI 03 363 9653, email graeme.wilson@oriongroup.co.nz

Yours sincerely

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