

## **Summary of the Commission's enforcement decisions in response to electricity distributors' non-compliance with the price path for the 2011 and 2012 assessment periods**

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## **Executive summary**

### **Purpose of paper**

- X1. The purpose of this paper is to explain the process and reasons behind the Commerce Commission's enforcement decisions in response to electricity distributors' non-compliance with the price path by:
- X1.1 Horizon Energy Distribution Limited (**Horizon**) for the 2012 assessment period;
  - X1.2 Wellington Electricity Lines Limited (**Wellington Electricity**) for the 2012 assessment period; and
  - X1.3 Orion New Zealand Limited (**Orion**) for the 2011 assessment period.

### **We settled out of Court with Horizon and Wellington Electricity in response to their failure to comply with the price path**

- X2. We entered into settlement agreements with Horizon and Wellington Electricity in response to their non-compliance with the price path for the 2012 assessment period.

### **The settlements will remove the gain to Horizon and Wellington Electricity that resulted from their non-compliance**

- X3. The settlements require Horizon and Wellington Electricity to remediate the amount gained from exceeding the price path. To do so, Horizon and Wellington Electricity must price below their price paths in a specified future period.
- X4. Having assessed Horizon and Wellington Electricity's non-compliance against the enforcement criteria, we considered that removing the gain they obtained as a result of failing to comply with the price path was the minimum response required to deter electricity distributors from failing to comply with the price path.<sup>1</sup>
- X5. We did not consider it necessary to seek a pecuniary penalty from Horizon or Wellington Electricity in Court as the non-compliance was inadvertent in both cases. Wellington Electricity exceeded its price path due to variances between its forecast and actual pass-through costs. This was also a significant contributor to Horizon's non-compliance, although, Horizon also made errors in calculating its proposed compliance position when setting prices.

### **We warned Orion for failing to comply with the price path**

- X6. We issued a warning letter to Orion in response to its non-compliance with the price path for the 2011 assessment period.

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<sup>1</sup> Deterrence is directed not only at Horizon and Wellington Electricity, but also at all other Non-exempt electricity distributors.

- X7. Under normal circumstances we would have required Orion to remediate the gain it obtained from exceeding the price path. However, we took into account that Orion earned considerably less than expected over the past three years due to the impact of the Canterbury earthquakes.

**We may take a stronger enforcement response in the event of a second instance of price path non-compliance**

- X8. We will take Horizon, Wellington Electricity and Orion's non-compliance into account in exercising our enforcement discretion in the event of a second contravention of the price path. Repeated non-compliance with the price path is more likely to lead us to seek a pecuniary penalty in Court.

**Electricity distributors must comply with the price path in every assessment period<sup>2</sup>**

- X9. The price path represents an annual price cap and it is an electricity distributor's responsibility to comply with it in every assessment period.
- X10. In the event of non-compliance we do not consider that an under recovery against the price path in a prior period can offset an over recovery against the price path in a later period. Nor do we consider an under recovery against the price path in a future period to be remediation for exceeding the price path in a prior period, unless the electricity distributor concerned can demonstrate that the under recovery was specifically intended as remediation. We may take such remediation into account in deciding on our enforcement response.
- X11. While such remediation will be considered as part of an investigation into non-compliance we will use our enforcement discretion and review every instance of non-compliance on its merits.

**We are receptive to resolving price path non-compliance out of Court by agreement**

- X12. We are receptive to resolving price path non-compliance out of Court by agreement where a settlement can be reached that fits with our enforcement criteria and is sufficient to achieve deterrence.

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<sup>2</sup> The Commission's expectations regarding price path compliance within this paper are expressed in regards to the price path within the *Electricity Distribution Services Default Price-Quality Path Determination 2012* [2012] NZCC 35 and the *Orion New Zealand Limited Customised Price-Quality Path Determination 2013* [2013] NZCC 21. We note that these may change when the *Electricity Distribution Services Default Price-Quality Path Draft Determination 2015* comes into force.

## Purpose of paper

1. The purpose of this paper is to explain the process and reasons behind the Commission's enforcement decisions in response to electricity distributors' non-compliance with the price path by:
  - 1.1 Horizon Energy Distribution Limited (**Horizon**) for the 2012 assessment period;
  - 1.2 Wellington Electricity Lines Limited (**Wellington Electricity**) for the 2012 assessment period; and
  - 1.3 Orion New Zealand Limited (**Orion**) for the 2011 assessment period.

## Structure of paper

2. This paper begins by explaining the nature of the price path obligations that electricity distributors failed to comply with for the 2011 and 2012 assessment periods and what our enforcement responses were. It then explains the reasons for our enforcement responses to those instances of non-compliance and the process we followed in deciding on our responses. Finally, the paper sets out our expectations regarding price path compliance.

## Three electricity distributors failed to comply with the price path

### Horizon, Wellington Electricity and Orion are subject to a price path

3. Part 4 of the Commerce Act 1986 provides that all suppliers of electricity lines services (other than those supplied by Transpower) are subject to default/customised price-quality regulation unless they are exempt.
4. Horizon, Wellington Electricity and Orion are not exempt from price-quality regulation and are each currently subject to a price-quality path determination that sets a price path they must comply with. The price path limits the aggregate prices an electricity distributor may charge.<sup>3</sup>
5. The default price-quality path that applied to Horizon, Wellington Electricity and Orion in the 2011 and 2012 assessment periods was set by the Electricity Distribution Services Default Price-Quality Path Determination 2010 (**Determination**) and applied to the regulatory period from 01 April 2010 to 31 March 2015.<sup>4</sup>

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<sup>3</sup> The price paths that relate to the 2011 and 2012 assessment periods are set out in the Electricity Distribution Services Default Price-Quality Path Determination 2010, available at: <http://www.comcom.govt.nz/dmsdocument/9542>.

<sup>4</sup> That price-quality path was subsequently reset in 2012 for all non-exempt electricity distributors except for Orion by the *Electricity Distribution Services Default Price-Quality Path Determination 2012* [2012] NZCC 35, which took effect on 1 April 2013. On 1 April 2014, Orion moved from a default price-quality path determination to a customised price-quality path determination (see *Orion New Zealand Limited Customised Price-Quality Path Determination 2013* [2013] NZCC 21).

6. Following each annual assessment period, all electricity distributors that are subject to default/customised price-quality regulation are required to provide us with an annual compliance statement which includes a report on their performance against the price path.
7. Horizon, Wellington Electricity and Orion were each required to provide us with a self-assessment against the price path for each assessment period.

#### **Orion failed to comply with the price path for the 2011 assessment period**

8. Orion reported non-compliance with its price path for the 2011 assessment period in its 2011 compliance statement.<sup>5</sup>
9. The reasons that Orion failed to comply with its price path are described in Attachment 3 to this paper.

#### **Horizon and Wellington Electricity failed to comply with the price path for the 2012 assessment period**

10. Horizon and Wellington Electricity both reported non-compliance with their price paths for the 2012 assessment period in their 2012 compliance statements.<sup>6</sup>
11. The reasons Horizon and Wellington Electricity failed to comply with their price paths are described in Attachments 1 and 2 to this paper.

#### **Contravention of a price-quality requirement under the Commerce Act 1986**

12. We consider that Horizon, Wellington Electricity and Orion have each contravened a price-quality requirement applying to regulated goods or services as described in section 87(1)(a) of the Commerce Act 1986 (**Act**).
13. For such contraventions, a Court may impose a pecuniary penalty of up to \$500,000 in the case of an individual or up to \$5,000,000 in the case of a body corporate.<sup>7</sup> A Court may also order compensation be paid to any person who has suffered, or is likely to suffer, loss or damage as a result of the contravention.<sup>8</sup>

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<sup>5</sup> Orion subsequently reported compliance with the price path for the 2012, 2013 and 2014 assessment periods in its 2012, 2013 and 2014 compliance statements.

<sup>6</sup> Horizon and Wellington Electricity subsequently reported compliance with the price path for the 2013 and 2014 assessment periods in their 2013 and 2014 compliance statements.

<sup>7</sup> Section 87(1)(a) of the Commerce Act 1986.

<sup>8</sup> Section 87A(1) of the Commerce Act 1986. Section 87A(1) applies where a Court has ordered a person to pay a pecuniary penalty under section 87 in respect of a contravention of a price-quality requirement. Section 87(1) only provides for an application for a pecuniary penalty by the Commission. The Commission has not applied for a pecuniary penalty under Section 87(1) in response to Horizon, Wellington Electricity or Orion's non-compliance with the price-quality path.

## **Our enforcement responses to non-compliance with the price path for the 2011 and 2012 assessment periods**

### **We settled out of Court with Horizon and Wellington Electricity**

14. We have entered settlement agreements with Horizon and Wellington Electricity in response to their non-compliance with the price path for the 2012 assessment period.

### **Terms of the settlements with Horizon and Wellington Electricity**

15. The settlement agreements with Horizon and Wellington Electricity contain similar obligations. The settlement agreements are available on our website.<sup>9</sup>
16. Under the respective settlement agreements, Horizon and Wellington Electricity:
- 16.1 acknowledged that they contravened a price-quality requirement applying to regulated goods or services as described in section 87(1)(a) of the Act;
  - 16.2 must remediate the amount they gained from exceeding the price path by pricing below their price paths in a specified future period;<sup>10</sup> and
  - 16.3 must demonstrate to us that they have factored the remediation of the agreed amount into their pricing for the relevant future period.
17. Subject to Horizon and Wellington Electricity meeting their obligations under the settlement agreements, the Commission agreed not to take further steps against them in relation to their 2012 price path non-compliance.

### **We issued a warning letter to Orion**

18. We issued a warning letter to Orion in response to its non-compliance with the price path for the 2011 assessment period. The warning letter is available on our website.<sup>11</sup>

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<sup>9</sup> Available at <http://www.comcom.govt.nz/default-price-quality-path-enforcement-responses/>.

<sup>10</sup> Wellington Electricity is required to remediate \$148,214 in the 2015 assessment period, and Horizon is required to remediate \$727,934 in the 2016 assessment period.

<sup>11</sup> Available at <http://www.comcom.govt.nz/default-price-quality-path-enforcement-responses/>.

## **Reasons for our enforcement responses to the non-compliance with the price path for the 2011 and 2012 assessment periods**

### **Our approach to deciding on the appropriate enforcement response to the three instances of non-compliance**

19. Using our enforcement criteria,<sup>12</sup> we analysed each instance of non-compliance from three perspectives:
  - 19.1 extent of detriment;
  - 19.2 seriousness of conduct; and
  - 19.3 public interest.
20. After assessing the non-compliance against these enforcement criteria, we considered the level of enforcement response required to deter electricity distributors from failing to comply with the price path.
21. In each case of price path non-compliance, there was detriment arising from distribution prices that were, on average, higher than allowed under the price path.
22. We assessed that the breaches in each case were inadvertent. However the detriment occurred irrespective of the reasons (i.e., seriousness of conduct) for the price path non-compliance.
23. There is also public interest in ensuring that electricity distributors do not gain as a result of exceeding the price path. This is important in deterring non-compliance with the price path.

### **Our decision to offer a settlement agreement in response to Horizon and Wellington Electricity's price path non-compliance**

24. We considered that removing the gain to Horizon and Wellington Electricity resulting from the non-compliance was the minimum response required to deter future non-compliance.
25. To remove the gain to Horizon and Wellington Electricity, we offered each the opportunity to settle its non-compliance out of Court on the basis that it remediates the commercial gain by pricing below their price path in specified future periods.

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<sup>12</sup> More detail on our enforcement criteria is available at: <http://www.comcom.govt.nz/enforcement-criteria/>.

26. We did not consider it necessary to seek a pecuniary penalty from Horizon or Wellington Electricity in Court as the non-compliance was inadvertent in both cases. Wellington Electricity exceeded its price path due to variances between its forecast and actual pass-through costs. This was also a significant contributor to Horizon's non-compliance, although, Horizon also made errors in calculating its proposed compliance position when setting prices.<sup>13</sup>
27. The reasons for the non-compliance, together with it being the first price path non-compliance under the customised/default price-quality path regime for either party, meant that we did not consider a pecuniary penalty necessary, provided we could remove any gain to Horizon and Wellington Electricity through a settlement.
28. Further, if these settlements turn out to be insufficient to deter Horizon and Wellington Electricity from failing to comply with the price path again, we may seek a pecuniary penalty in Court next time.

#### **Our decision to issue a warning letter in response to Orion's price path non-compliance**

29. Similar to Wellington Electricity, Orion's non-compliance with the price path was inadvertent and due to variances between its forecast and actual pass-through costs.
30. Under normal circumstances, we would have sought to remove the amount Orion gained as a result of exceeding the price path, as we did for Horizon and Wellington Electricity. However, we took into account that Orion earned considerably less than expected over the past three years due to the impact of the Canterbury earthquakes.
31. Given this exceptional circumstance, we decided not to require remediation from Orion, and instead issued Orion with a warning letter. We did not consider, in the context of Orion's ongoing and significant earthquake response, that seeking recovery of Orion's relatively minor gain would promote the Part 4 purpose.
32. In responding to non-compliance with price-quality requirements, we use warning letters as an alternative to seeking a pecuniary penalty or compensation where:
  - 32.1 we consider that a supplier is non-compliant; but
  - 32.2 we do not consider that, in the circumstances, a stronger response is necessary to achieve deterrence.

#### **Our process for responding to the non-compliance with the price path for the 2011 and 2012 assessment periods**

##### **We considered the reasons for each instance of non-compliance**

33. To inform our analysis of each case of non-compliance against the enforcement criteria, we sought to establish the reasons for the non-compliance in each case.

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<sup>13</sup> More detail on the reasons for the non-compliance is contained in the attachments to this paper.

34. Horizon, Wellington Electricity and Orion's compliance statements, which were audited and director certified, clearly outlined the reasons for their non-compliance. Accordingly, only limited additional investigation was required.
35. We then considered the factors that contributed to each instance of non-compliance against our enforcement criteria, and reached an enforcement decision, as described above.

### **Settlement process**

36. Having decided that we were prepared to settle the non-compliance out of Court rather than seek pecuniary penalties, we wrote to Horizon and Wellington Electricity and set out our settlement offer.
37. Our settlement offers to Horizon and Wellington Electricity made it clear that our alternative to reaching a settlement removing the gain to the businesses from their non-compliance was taking Court proceedings in order to remove the gain via a Court-ordered pecuniary penalty.
38. We held settlement discussions with both Wellington Electricity and Horizon and reached agreement on the settlement terms.

### **The settlement amounts**

*The settlement amounts are intended to remove the gain resulting from the non-compliance*

39. For both the Wellington Electricity and Horizon settlements, we calculated the amount of remediation we were prepared to settle on based on our assessment of the gain to the electricity distributor as a result of the non-compliance.
40. In assessing the gain, we used actual quantity figures, rather than the lagged quantity figures used to calculate compliance, in order to better reflect the gain obtained by the electricity distributor from its higher-than-compliant prices.
41. In assessing the gain, we also factored in a time value of money adjustment to ensure that Horizon or Wellington Electricity does not gain from the use of the over-recovered amount between the 2012 assessment period and the assessment period in which remediation is to occur.

*The settlement amount agreed with Horizon recognises that Horizon made partial remediation in the 2014 and 2015 assessment periods*

42. Horizon produced evidence to demonstrate that its under recovery in the 2014 and its forecast 2015 under recovery were, in part, intended as remediation of its 2012 price path non-compliance.

43. We therefore agreed to recognise one third of Horizon's 2014 and 2015 under recoveries as remediation and deducted this from our assessment of the gain to Horizon resulting from its non-compliance. This was based on our assessment that, while Horizon's under recovery in 2014 and its forecast 2015 under recovery were, in part, intended as remediation of its 2012 price path non-compliance, a significant driver of Horizon's purpose for targeting an under recovery in 2014 and 2015 was to mitigate the risk of failing to comply with the price path again.

## **Our expectations regarding price path compliance**

### **Electricity distributors must comply with the price path in every assessment period**

44. The price path represents an annual price cap and it is the responsibility of electricity distributors to comply with it in every assessment period.
45. In the event of non-compliance we do not consider that an under recovery against the price path in a prior period can offset an over recovery against the price path in a later period. Nor do we consider an under recovery against the price path in a future period to be remediation for exceeding the price path in a prior period, unless the electricity distributor concerned can demonstrate that the under recovery was specifically intended as remediation. We may take such remediation into account in deciding on our enforcement response.
46. While such remediation will be considered as part of an investigation into non-compliance we will use our enforcement discretion and review every instance of non-compliance on its merits.
47. Demonstrable intention to under recover is an important aspect of remediation because, absent intention, the under recovery would occur anyway, independent of the non-compliance, i.e. the supplier is not in fact seeking to pay back any of the previous over recovery.
48. As part of the settlements with Horizon and Wellington Electricity, we therefore require Horizon and Wellington Electricity to demonstrate to us that they have intentionally factored the agreed remediation amount into their pricing for the relevant agreed future periods.
49. While we did not seek pecuniary penalties against Horizon, Wellington Electricity or Orion, we will take their non-compliance into account in exercising our enforcement discretion in the event of a second contravention of the price path. Repeat non-compliance with the price path is more likely to lead us to seek a pecuniary penalty in Court, as well as compensation.

### **Our approach to settlements for price path non-compliance**

50. We are receptive to resolving price path non-compliance out of Court by agreement where a settlement can be reached that fits with our enforcement criteria and when it is sufficient to achieve deterrence.

51. We do not approach settlement discussions as commercial negotiations.

## **Closing remarks**

### **We appreciated the cooperation of the parties**

52. We appreciated the cooperation of Horizon, Wellington Electricity and Orion during our investigation and response to the price path non-compliance.

### **Forecasting risk**

53. We acknowledge that electricity distributors face forecasting risks when setting prices. This issue is currently being considered as part of the reset of the default price-quality path for electricity distributors.
54. However, irrespective of the reasons for an electricity distributor failing to comply with the price path, a supplier should not generally be allowed to retain any amount recovered in excess of the price path.

### **Clarification of the revenue differential term**

55. There was some misunderstanding of the effect of the revenue differential term by suppliers.<sup>14</sup>
56. The revenue differential term simply prevents an over recovery in one period from impacting the price path by increasing allowable notional revenue in the next period. The revenue differential term does not decrease allowable notional revenue to compensate for an over recovery in the previous period. Therefore, the revenue differential term does not automatically remediate an over recovery.<sup>15</sup>

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<sup>14</sup> This revenue differential term is represented in the allowable notional revenue formula as  $R_{t-1} - NR_{t-1}$ . See clause 8.4 of the Electricity Distribution Services Default Price-Quality Path Determination 2010, available at: <http://www.comcom.govt.nz/dmsdocument/9542>.

<sup>15</sup> See *2010-2015 Electricity Distribution Default Price Quality Path Revenue Differential Term Amendment Reasons Paper*, 30 November 2010, available at: <http://www.comcom.govt.nz/dmsdocument/429>.

## Attachment 1: Horizon's non-compliance

### Horizon's network

1. Horizon's electricity distribution network area covers the eastern Bay of Plenty.
2. Horizon supplies over 25,500 consumer connections.
3. Horizon is a publicly listed company which includes a number of subsidiaries. The Eastern Bay Energy Trust holds 77.4% of the shareholding on behalf of the consumers connected to the Horizon's network.

### Horizon's 2012 price path non-compliance

4. Horizon's compliance statement for the 2012 assessment period shows and states that Horizon was non-compliant with the price path.
5. Horizon was non-compliant with the price path in 2012 because its notional revenue exceeded its allowable notional revenue.
6. Horizon's performance against the price path for 2012 is represented by the table below. The table indicates that Horizon exceeded its price path by \$645,686. This equates to an over recovery of 3.16% of total allowable notional revenue.

### Horizon's performance against the price path for the for the 2012 assessment period

Allowable notional revenue	\$20,410,487
Notional revenue	\$21,056,173
Recovery in excess of price path (i.e., notional revenue – allowable notional revenue)	\$645,686 <sup>16</sup>
Over recovery as a percentage of allowable notional revenue	3.16%

Source: Horizon's 2012 DPP Compliance Statement

<sup>16</sup> This amount differs from the \$727,934 Horizon is required to remediate in the 2016 assessment period because the settlement amount adjusts for actual quantities, the time value of money, and partial remediation by Horizon in the 2014 and 2015 assessment periods. See paragraphs 39 – 43 for more detail on how the settlement amount was calculated.

**Reasons for Horizon's failure to comply with the price path**

7. The reasons for Horizon's non-compliance can be split into six components. These are factors associated with:
  - 7.1 the timing and forecasting of avoided transmission costs as a result of embedded generators operating on Horizon's network;
  - 7.2 forecasting of local authority rates and regulatory levies;
  - 7.3 forecasting of movements in lagged quantities following a pricing restructure;
  - 7.4 setting standard prices prior to finalising pricing for non-standard customers;
  - 7.5 forecasting 2012 allowable notional revenue; and
  - 7.6 errors in calculating the forecast compliance position.
8. Further explanation of Horizon's non-compliance can be found in Horizon's 2012 compliance statement.<sup>17</sup>

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<sup>17</sup> Horizon's 2012 compliance statement is available on its website at:  
<http://www.horizonenergy.net.nz/disclosures/default-price-quality-path-compliance>.

## Attachment 2: Wellington Electricity's non-compliance

### Wellington Electricity's network

1. Wellington Electricity's electricity distribution network area covers Wellington, Porirua, Lower Hutt and Upper Hutt.
2. Wellington Electricity supplies over 160,000 consumer connections.
3. Wellington Electricity is indirectly wholly owned by Cheung Kong Infrastructure Holdings Limited and Power Assets Holdings Limited. Both of those companies are members of the Cheung Kong group of companies and are listed on the Hong Kong Stock Exchange.

### Wellington Electricity's 2012 price path non-compliance

4. Wellington Electricity's compliance statement for the 2012 assessment period shows and states that Wellington Electricity was non-compliant with the price path.
5. Wellington Electricity was non-compliant with the price path in 2012 because its notional revenue exceeded its allowable notional revenue.
6. Wellington Electricity's performance against the price path for 2012 is represented by the following table.

#### Wellington Electricity's performance against the price path for the 2012 assessment period

Allowable notional revenue	\$103,161,576
Notional revenue	\$103,278,333
Recovery in excess of price path (i.e., notional revenue – allowable notional revenue)	\$116,757 <sup>18</sup>
Over recovery as a percentage of allowable notional revenue	0.11%

Source: Wellington Electricity's 2012 DPP Compliance Statement

<sup>18</sup> This amount differs from the \$148,214 Wellington Electricity is required to remediate in the 2015 assessment period because the settlement amount adjusts for actual quantities and the time value of money. See paragraphs 39 – 41 for more detail on how the settlement amount was calculated.

**Reasons for Wellington Electricity's failure to comply with the price path**

7. Wellington Electricity's non-compliance was mainly due to a minor variation between forecast and actual pass-through costs. More detail on the variation between Wellington Electricity's forecast and actual pass-through costs can be found in Wellington Electricity's 2012 compliance statement.<sup>19</sup>

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<sup>19</sup> Wellington Electricity's 2012 compliance statement is available on its website at: <http://www.welectricity.co.nz/disclosures/Pages/Threshold%20Compliance.aspx>.

### Attachment 3: Orion's non-compliance

#### Orion's network

1. Orion owns and operates the electricity distribution network in central Canterbury between the Waimakariri and Rakaia rivers, and from the Canterbury coast to Arthur's Pass.
2. Orion's network is contained within the boundaries of the two local councils that own Orion, Christchurch City Council (which owns 89.3%) and Selwyn District Council (which owns 10.7%).
3. Orion supplies just over 189,000 consumer connections.

#### Orion's 2011 price path non-compliance

4. Orion's compliance statement for the 2011 assessment period shows and states that Orion was non-compliant with the price path.
5. Orion was non-compliant with the price path in 2011 because its notional revenue exceeded its allowable notional revenue.
6. Orion's performance against the price path for 2011 is represented by the following table.

#### Orion's performance against the price path for the 2011 assessment period

Allowable notional revenue	\$132,689,000
Notional revenue	\$132,814,600
Recovery in excess of price path (i.e., notional revenue – allowable notional revenue)	\$125,600
Over recovery as a percentage of allowable notional revenue	0.09%

Source: Orion's 2011 DPP Compliance Statement

#### Reasons for Orion's failure to comply with the price path

7. Orion's non-compliance was mainly due to a minor variation between forecast and actual pass-through costs. More detail on the variation between Orion's forecast and actual pass-through costs can be found in Orion's 2011 compliance statement.<sup>20</sup>

<sup>20</sup> Orion's 2011 compliance statement is available on its website at:  
<http://www.oriongroup.co.nz/publications-and-disclosures/regulatory-disclosures.aspx>.