

# PRICING REVIEW

## STEPS TAKEN TO PREVENT FUTURE CONTRAVENTION OF THE PRICE PATH

### Background

Firstlight Network is subject to default price-quality regulation under Section 54G of the Commerce Act 1986. In regulatory period 2020, Eastland Network (known as Firstlight Network since April 2023) was subject to Default Price-quality Path 2 (DPP2), which limits the amount of notional revenue that Eastland Network could earn in each annual assessment period to its allowable notional revenue.

For the 2020 Assessment Period, Eastland's allowable notional revenue was \$27,366,386 and its notional revenue was \$27,693,433. Due to mistakenly including pass-through prices in the prices for certain Tariff Codes leading to incorrect understatement of its notional revenue, Eastland's notional revenue exceeded its allowable notional revenue by \$327,047 and it therefore charged consumers \$327,047 more than it was entitled to charge under the DPP Determination 2015.

The Commission exercised its enforcement discretion and made a decision not to seek the imposition of a criminal penalties under s 87B of the Act against Eastland in respect of contravention of the Price Path.

The Commission has accepted Enforceable Undertakings (EUs) and agreed to resolve the Contravention of the Price Path on the terms set out in the EUs summarised below.

The Commission and Eastland agreed that the most expedient mechanism for refunding the overcharge and providing compensation to consumers is for Eastland to provide a rebate to customers via electricity retailers.

### Summary of the Enforceable Undertakings

#### **Rebate – completed in 2021**

- a. The Rebate consists of overcharge (\$327,047) and time value of money charge (\$28,253) (5.1.1).
- b. Notice to retailers within 10 working day of the Commencement Date (CD), giving retailers maximum of 45 working days to pass a rebate to consumers (5.1.2). Commencement Date will be the date Eastland signs the agreements.
- c. Within 5 working days of receiving confirmation from an electricity retailer of the total amount credited to consumers' accounts, pay the Rebate to that electricity retailer up to the amount credited to consumers (5.1.3).
- d. Eastland to cover retailers' reasonable costs associated with the rebates (5.1.4).

#### **Reporting - completed**

Submit a report to the Commission within 65 working days of CD setting out rebate amount per ICP per tariff code, total amount by tariff code, number of consumers within each tariff code, rebates failed to be passed on by a retailer.

#### **Public Statements - completed**

- a. Statement on our website explaining the rebates and recognise the Contravention. To be published within 20 working days of the Commission's approval of the text. Statement is to remain on the website for 80 working days.
- b. Include promotional material to be included with the invoice to retailers that will explain the fact the rebate is made to recognise the fact of consumer having been overcharged (text to be approved by the Commission)

#### **Independent Review – Report by Adri Smit (PwC) was completed on 26 Oct 2023 and provided to the Commission on the same day**

- a. Engage Adri Smit to review and report on the effectiveness of the price-setting processes at ensuring compliance with price path within 30 working days of CD and provide the report to the Commission as soon as completed (5.1.9).
- b. Provide the report to the Commission within 40 working day of completion of independent review report (by 20 Dec 2023) with steps Eastland has taken in response to any recommendation (5.1.10).

- c. Publish both independent review report and steps taken report alongside the Annual Compliance Statement.
- d. The Commission will make this Undertaking publicly available.
- e. The Commission may make public references to this Undertaking, including in media statements.

This report pertains to clause 5.1.10 of the Enforceable Undertakings and concludes the actions required under the set-out terms.

## **INDEPENDENT REVIEW**

As per clause 5.1.9. of the EUs, Eastland engaged Adri Smit (PwC) to conduct an independent Pricing review. This review was completed on 26 October 2023 and submitted to the Commerce Commission on the same day.

The following areas were in-scope of the PwC Pricing Review:

- Understanding of the price setting processes through interviews and walkthroughs with relevant Eastland management including:
  - Roles and responsibilities;
  - Systems and process used; and
  - Oversight and review activities

Under the above-mentioned scope PwC reviewed the price setting policies and procedures in place, obtained a copy of the price setting model in order to understand key data inputs required and to review the model integrity. The review also identified and tested key controls in place to ensure compliance with the price path, accuracy of the price setting model and completeness and accuracy of information used in the model when setting prices.

The Independent review report recommended improvements required to enable future compliance with the pricing regulations through an effective price setting process.

It is important to note that RY2020, when the breach occurred, was the last year under the DPP2 regulatory period (effective 1 April 2015 to 31 March 2020) and the price setting requirements have changed under DPP3 (effective 1 April 2020 to 31 March 2025). As the objective of the independent review was to ensure future compliance, PwC reviewed processes relevant under DPP3 rather than the historic DPP2. As a result, the independent review was mainly focussed on the price setting for RY2021 and RY2022.

## **Independent Review Findings**

### **Roles and responsibilities**

The price setting process relies heavily on a key person who is also responsible for ensuring regulatory compliance.

The areas for which processes were reviewed were:

1. Price-setting Compliance Statement
2. Forecast Allowable Revenue; and
3. Forecasting Revenue from Prices

### **Recommendation:**

Roles and responsibilities around the price setting and compliance activities need to be formalised. The roles and responsibilities assigned should ensure sufficient segregation of duties and knowledge within the team to allow for an effective review process.

### **Systems and processes used including the price-setting model**

The price setting process is mostly manual with significant reliance on spreadsheets. The spreadsheets do not have appropriate internal quality checks and restrictions.

### **Recommendation:**

Spreadsheets used for price setting should be restricted and reviewed to identify areas of improvement such as through the use of formulas rather than hardcoding, building in internal quality checks and adding guidance/instructions that can be followed.

Reconciliations to supporting systems and data quality checks over those systems have not been performed prior to use of the information in the price setting process.

Recommendation:

Reconciliations should be performed to supporting systems to ensure complete and accurate data is used for inclusion in the pricing spreadsheets. Quality checks should be performed over the data to ensure it is reliable and appropriate for price setting purposes. At times, adjustments may be required to financial or other data to ensure regulatory compliance.

**Oversight and review activities**

The company has improved its oversight and review activities through specified procedures performed over the pricing model prior to issuance of the price setting compliance statement.

Recommendation:

PwC recommend management formalise the oversight and review activities either in house if appropriate resource and capabilities are available or alternatively ensure external review.

**Policies and procedures**

Policies or procedures relating to the price setting process have not been formalised or documented.

Recommendation:

PwC recommend management formally document the price setting process, consider formalising a pricing policy and expand on the disclosures around the process and methods used in setting prices in the annual price setting compliance statement.

**MANAGEMENT RESPONSE**

**Roles and responsibilities:**

There was a significant key person risk identified with Regulatory and Pricing Manager taking responsibility for all price setting activities and process had not been formalised or documented.

In 2021, the management responded to the breach by introducing a new structure under Regulatory and Pricing Manager, which also included a Regulatory and Pricing Analyst to achieve segregation of duties. Recruitment for this new role was completed in December 2021. The training of this new analyst included formalising processes and recording process notes using Microsoft OneNote.

As mentioned in the Independent Review, there was also a new process introduced in November/ December 2021 which included an independent review of the Price-setting Compliance Statement by PwC and a more comprehensive pricing paper was produced annually to the Board supporting the price setting compliance.

In April 2023, Eastland Network (now Firstlight Network) was acquired by Firstgas Group (now Clarus). This change increased the size of the team and significantly improved the expertise within and beyond the price setting area. Price-setting Compliance Statement and Forecast Allowable Revenue calculation are now a responsibility of Clarus Regulatory Team, which has extensive experience with regulated suppliers and robust internal review processes. Forecasting revenue from prices is the responsibility of a two-person team at Firstlight Network (Commercial Analyst and Commercial Manager) allowing for sufficient internal review. Any outputs from the Commercial team and the Regulatory team are now further reviewed by the Executive management level at Clarus, specifically General Manager Customer & Regulatory.

**Systems and processes used including the price-setting model;**

Spreadsheets used for price setting have since been restricted to use by regulatory team only and integrity has been improved by including checks where possible and using links/formulas rather than hardcoding. Instructions have been formalised by the Clarus Regulatory team by including Firstlight process into the wider business process.

The review report highlighted the focus is on performing reconciliations, implementing quality checks, and making necessary adjustments to ensure our pricing spreadsheets are based on complete, reliable, and regulatory-compliant information.

We have reinforced our reconciliation procedures to include an audit of supporting systems. This will ensure that data discrepancies are promptly identified and resolved, minimising the risk of inaccuracies in our pricing model and price-setting templates.

The systems and processes used in setting prices are mostly manual with significant reliance on spreadsheets. As a response to this, in 2022 we engaged Energia Consulting (Richard Krogh) to review our pricing model and improve the integrity of the model by added checks. Pricing manual has been compiled to further reduce the risk of errors within the pricing process.

The process notes and guidelines specifically focus on mitigating the risk of reconciliation error between the price setting templates and finance spreadsheets concerned with budgets supporting the price setting compliance.

The Price Setting Model itself has built-in guidance, DPP Determination references and integrity checks to limit the risk of error. However, the independent review highlighted a risk of the model relying on inputs from other source files prepared by management.

As a response, we have initiated a documentation process for spreadsheets used as inputs into the price setting model. Each spreadsheet now includes clear instructions, and any hard-coded numbers have documentation. This enhancement ensures that the rationale behind decisions is transparent and aids in better understanding and follow-up.

To address the issue of limited quality/integrity checks, we have introduced standardised procedures to ensure consistent and thorough checks across all data sources. These checks are designed to identify and rectify errors promptly, improving the overall reliability of the data used in the pricing model.

We have implemented a robust version control system to prevent instances where data is linked from different versions of the same spreadsheet. This ensures that only the most up-to-date information is utilised in calculations, reducing the risk of outdated information impacting our pricing decisions.

Recognising the importance of formalised processes, we have established clear procedures for reconciliations and quality checks. This includes audits to ensure that the information used is complete and accurate, providing a structured framework for maintaining data integrity.

The independent review further highlighted that forecasting consumption and demand is becoming more difficult with uncertainties over the impact of consumer behaviour due to decarbonisation and changing weather patterns. Historic trends can no longer be relied upon to produce reliable forecasts and a multi-tiered approach is necessary to produce a good forecast.

Despite volumes forecasting not causing material variances in revenue, we continue to improve our methods, which include a combination of historical data, Transpower's Whakamana i Te Mauri Hiko predictions and qualitative data directly from our commercial and industrial consumers.

We have also formalised the quantity forecasting process by writing up a process to follow for any new starters but also to avoid parts of the process being missed by the existing analysts.

### **Oversight and review activities**

The independent review found improvements in our oversight and review activities through specified procedures performed over the pricing model prior to issuance of the price setting compliance statement.

This was formalised as an annual review by PwC of our Price-setting compliance statement before issuance of 2022-23 and 2023-24 price setting compliance statements. These reviews happened during November/December and assurance report was included alongside the statement when presented for certification by the Board.

For the 2024-25 price setting process, Firstlight has adopted a robust review process where the Clarus Regulatory team prepares price setting statements and allowable revenue calculations for all regulated businesses within the group (Firstgas transmission, Firstgas distribution and Firstlight electricity distribution). The Firstlight commercial team reviews these calculations against expectations of revenue, and final price-related regulatory disclosures are reviewed and approved by the Clarus General Manager Customer & Regulatory.

The Firstlight price setting processes have been included in the wider price setting manuals and procedures.

**Policies and procedures**

Clarus policies or procedures relating to the price setting process have been adopted to Firstlight processes. In addition to the regulatory price setting process and allowable revenue calculation (described above), the pricing model process has been documented and linked in spreadsheet include an instructions page to ensure integrity of the overall process.

Firstlight policy and methodology has improved significantly since the 2020, which saw an improvement in EA pricing score from 1.5 to 4.1, change in pricing methodology, which included a refresh of the pricing model (in 2022) improving not only cost reflectivity, but the overall model integrity.

Forecast accuracy is also improving (RY23 saw only 0.5% difference between forecast revenue from prices and actual revenue from prices), suggesting that the current forecast model and process has reached a reasonable level of maturity and does not necessitate any urgent improvements.

The independent pricing review confirmed that the Price-Setting Compliance Statements are reviewed and approved by those charged with governance prior to issuance. It also gathered evidence of the management engaging an independent expert to perform agreed upon procedures on the price setting model for consistency with the DPP Determination for RY22 and RY23.

Management consider all recommendations from the independent review implement and that the steps taken in response to the price path breach in RY2020 will prevent future contravention of the price path.