

27 September 2010

Matthew Lewer
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Dear Matthew

SUBMISSION ON THE COMMERCE COMMISSION'S DISCUSSION AND DRAFT DECISIONS FOR DPP REFINEMENTS

Aurora Energy Limited (Aurora) wishes to make the following submission on the Commerce Commission's proposed refinements to the default price-quality path (DPP). This is in response to the Discussion and Draft Decisions Paper¹ published by the Commission on 13 August 2010 (the *Refinements Paper*).

Introduction

In its *Refinements Paper*, the Commission is opening/furthering its consultation on several issues that had previously been signalled for consultation, including:

- i. the need for a headroom (or revenue differential) term;
- ii. definitions of pass-through costs and recoverable costs;
- iii. specifying applicable Input Methodologies;
- iv. the application window for a customised price-quality path (CPP);
- v. EDB merger and acquisition transactions; and
- vi. the circumstances in which the DPP may be reconsidered.

The *Refinements Paper* provides the Commission's Draft Decisions on having a headroom term included in the DPP. These Draft Decisions are accompanied by an amended determination and a consolidated/amended determination in the Appendices to the *Refinements Paper*. The other elements of the *Refinements Paper* listed above are provided for discussion purposes—rather than as Draft Decisions.

In addition, the *Refinements Paper* proposes an adjustment to the actual consumer price index (CPI) to remove the impact of the GST increase that occurs on 1 October 2010 (i.e. to reduce prices that would otherwise occur under the CPI-X price path). The Commission has taken the view that the impact of GST increases on the CPI will give rise to windfall gains by electricity distribution businesses (EDBs).

¹ Commerce Commission; "2010-2015 Electricity Distribution Default Price-Quality Path Refinements – Discussion and Draft Decisions Paper"; 13 August 2010

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Aurora's Submission on the Refinements Paper

Aurora's comments/views are as follows:

1. Inclusion of a Headroom / Revenue Differential Term in the DPP

EDBs are required to estimate prices that are compliant with a CPI-X price path specified by the Commission. The price path is currently specified for a 5 year regulatory period.

In practice, many EDBs set their prices lower than this to avoid a technical breach that may arise from estimation errors. However, these lower prices then set the new reference point for price compliance in the following year. In effect, by building a buffer for estimation error each year, an EDB's prices may depart from the original 'approved' price path by a considerable margin over the regulatory period (i.e. a compounding effect).

The proposed headroom term allows EDBs to build a buffer / headroom into their prices (to avoid a technical breach), without having the 'lower prices' default as the new reference point for price compliance each year. It also means that, where an EDB's prices exceed the approved price path (for whatever reason), these higher prices are not treated as the reference point for compliance in the following year. The headroom term, as proposed, relates to pricing within a regulatory period—rather than pricing issues from one regulatory period to another.

Aurora's Comment

Aurora supports the Commission's Draft Decisions on the headroom (i.e. revenue differential) term. In addition:

- ◆ Aurora agrees with the formulation of the revenue differential term set out in the Appendices to the *Refinements Paper*.
- ◆ Aurora also supports the proposal that, when the DPP is reset at the end of a regulatory period, headroom from the previous DPP may be taken into account. This applies where the DPP is reset with the new starting prices being the closing prices from the previous DPP (as per section 53P(3)(a) of the Commerce Act 1986).

53P Resetting starting prices, rates of change, and quality standards

- (1) *Before the end of the first and every subsequent regulatory period, the Commission must amend the section 52P determination by setting out the starting prices (as referred to in section 53O(a)), rates of change (as referred to in section 53O(b)), and quality standards (as referred to in section 53O(c)) that apply for the following regulatory period.*
- (2) *In resetting starting prices, rates of change, and quality standards, the Commission must consult with interested parties.*

- (3) *The starting price adjustments must be either –*
- (a) *the prices that applied at the end of the preceding regulatory period; or*
 - (b) *prices, determined by the Commission, that are based on the current and projected profitability of each supplier.*
- (4) *Starting prices set in accordance with subsection (3)(b) must not seek to recover any excessive profits made during any earlier period. ...*

Aurora is, however, concerned with the Commission's comment that "*the Commission considers that, to the extent a breach of the price-path in the previous regulatory period affects the starting price adjustment process, the supplier should not benefit from this breach*"². This is in the context of the DPP being reset independently of the closing prices from the previous DPP (as per section 53P(3)(b) of the Act). Whilst accepting that, in principle, an EDB should not benefit from a breach, Aurora is concerned that:

- the Commission may be considering punitive recourse in the case of a 'technical breach';
- the Commission's concerns with 'breaches' appear one-sided, and the Commission should also be concerned that EDBs may also under-recover in a previous regulatory period; and
- the Commission's comments³ may suggest that the same breach could give rise to different outcomes (depending on how the Commission decides to specify starting prices).

Punitive corrections would be inconsistent with the principle of having a headroom term in the first place. Aurora urges the Commission to allow the headroom term to be carried over from one DPP to the next—irrespective of the form of starting price adjustment under s53P(3) of the Act.

2. Definitions of Pass-through Costs and Recoverable Costs

In its determination of Input Methodologies, the Commission has formed a view on the definition of Pass-through Costs. Recently, these views were set out in the Commission's draft decisions on Input Methodologies⁴, and submissions have been made on these views. In short, the Commission has proposed a very 'tight' definition for Pass-through Costs.

Under this definition, the likes of transmission charges (which, in the past, have been treated as a pass-through costs in the setting and assessing of price paths) are no longer deemed to be Pass-through Costs.

² see *Refinements Paper* para. 2.27

³ In paras 2.26 and 2.27 of the *Refinements Paper*

⁴ Commerce Commission; "Input Methodologies (Electricity Distribution Services) – Draft Reasons Paper"; 18 June 2010 (hereinafter referred to as the *Draft Reasons Paper*)

The Commission has instead proposed a new category of cost—termed ‘Recoverable Costs’—that apply to “*partially controllable costs that the Commission considers it may be appropriate to allow to be fully recoverable from consumers*”⁵. The Commission proposes that “*Recoverable Costs will be reviewed prior to the commencement of each regulatory period, with a view to determining whether they should remain, in whole or in part, as Recoverable Costs for the next regulatory period*”⁶.

The Commission proposes that the price path assessment formula would include a ‘V’ term for Recoverable Costs. This ‘V’ term would coexist with, and apply in the same way as, the existing ‘K’ term for Pass-through Costs.

In its Draft Reasons Paper, the Commission sets out the rationale for categorising costs in this manner:

“The Commission considers it is important to treat Recoverable Costs separately from pass-through costs because:

- a. retaining tightly defined Pass-Through Cost Criteria removes the need for the Commission to be involved in assessing the reasonableness of costs once they have been defined as pass-through costs, as by definition they are outside a supplier’s control; and*
- b. having a recoverable cost recovery cost category provides for costs that do not meet the Pass-Through Cost Criteria, but where practical regulatory design issues preclude the costs from being treated the same way as those costs that can be explicitly provided for in the price-quality path in advance. It also provides more options and flexibility (relative to pass-through costs), including application of incentives, and partial pass-through of certain costs.*⁷

Aurora’s Comment

Whilst accepting that it is appropriate (and important) to have incentives to achieve cost efficiencies, Aurora is concerned that the Commission’s proposed definitions will create uncertainty. In this regard, Aurora notes the Electricity Networks Association (ENA) submission⁸ on the *Draft Reasons Paper* (which was endorsed by EDBs including Aurora):

*“We support the Commission’s intention to develop a mechanism that has the potential to provide incentives for EDBs to manage some Pass-Through Costs. **The proposed approach in the Draft Determination provides the Commission a high degree of discretion, with no guidance or constraints on the exercise of that discretion** (contrary to subsection 52T (2)). We consider the appropriate approach to developing incentive mechanisms in this context is to develop a procedure for the Commission and an EDB to agree such incentive arrangements, including under a DPP, with the default being a 100% pass-through. ...*

The Commission proposes an approach to avoided transmission charges that aims to incentivise improvements in the efficiency of the overall provision of electricity lines services. Under the Commission’s approach EDBs will have to seek the Commission’s approval to include the avoided transmission charges. ...

*The ENA is concerned about the “efficiency test” that would be applied by the Commission in seeking to approve the Recoverable Cost or not. We submit that a better approach is for the Commission to adopt its recoverable cost framework, but omit the efficiency test. This would ensure that transaction costs and risks for EDBs are lowered, in pursuit of these desirable efficiencies. ...”*⁹ [Emphasis Added]

⁵ see *Draft Reasons Paper* para. 8.4.17

⁶ see *Draft Reasons Paper* para. 8.4.16

⁷ see *Draft Reasons Paper* para 8.4.21

⁸ Electricity Networks Association; “Submission 5: Processes and Rules Input Methodology”; 9 August 2010

⁹ *Ibid*, paras 6, 11, 12

In addition to the uncertainty that these proposed definitions may engender, Aurora is concerned that important elements of *avoided transmission charges* have been omitted from the Commission's proposals. These elements include:

- ◆ Existing embedded generation contracts

Aurora has contracts of this nature which require the payment of 'avoided transmission charges'. The Commission's Draft Reasons Paper does not include such costs in its "initial list of recoverable costs for EDBs"¹⁰. Aurora believes that these costs should remain as Pass-through Costs.

In particular, it should be noted that avoided transmission payments made to embedded generators can be highly variable (and therefore not controllable or predictable) depending on the coincidence of wind or hydro generation with the regional transmission peak demands. Low hydro situations can also impact on a generator's ability to reduce transmission peaks.

Aurora has seen variations of 12% per annum in Transpower charges as a result of the ability of embedded generators to reduce or not reduce transmission charges.

Again Aurora notes/endorse ENA's submission on this issue:

*"The Commission has not, in its Draft Determination of Pass-Through /Recoverable Costs, provided for avoided transmission charges that the distributor pays to distributed generators, despite this being outside of the distributor's control (being a requirement of the Electricity Governance (Connection of Distributed Generation) Regulations 2007) and currently included in the DPP as a Pass-Through Cost. This appears to be an omission, as there is no discussion in the Draft Reasons Paper on excluding these avoided transmission charges. The ENA submits that the Commission must re-instate this into the Pass-Through /Recoverable Cost category."*¹¹

- ◆ Transmission assets acquired from Transpower

Avoided transmission charges may arise where an EDB acquires assets (e.g. spur line assets) from Transpower. This can create efficiency benefits where an EDB operates these assets at a lower cost than Transpower. The Commission proposes that an EDB can keep these benefits for 5 years. However, the Commission's proposals are silent on how this will work in practice where the 5 year retention period does not coincide with the start/finish of a regulatory period.

For example, after 5 years, the EDB will no longer be able to recover, as a Recoverable Cost, the former 'nominal' transmission charge that is avoided. Once the 'V' term is reduced in this manner, an EDB will breach their price path control unless a mechanism is provided to enable the recovery of the 'actual costs' an EDB incurs in operating these transmission assets itself.

¹⁰ see *Draft Reasons Paper* para. 8.4.15

¹¹ *Supra*, Note 8, para 13

Aurora supports ENA's comments on this issue:

*"The Commission does not specify what is to happen to recoverable avoided transmission charges costs arising from an EDB purchasing transmission assets from Transpower after the end of a five year period. An adjustment is required to the EDB's DPP so that the EDB can recover the ongoing operating and capital costs associated with the investment, which would then form part of its cost base. Any such DPP adjustment is best undertaken at the reset of a DPP. To facilitate this, the ENA recommends that the five year period (for recovering avoided transmission charges) is extended to the period equivalent to the DPP reset which immediately follows the five year period from which the initial investment is made."*¹²

Finally, Aurora notes that the Commission proposes that charges payable to Transpower under a New Investment Contract (NIC) are to be categorised as Recoverable Costs. Aurora notes that NICs are not avoidable. Major upgrades in (say) connection assets are deferred as long as possible, but ultimately an upgrade must take place with a consequent (large) increase in transmission charges. Whilst the timing of NICs may be controllable to some extent, the charge itself is neither controllable nor avoidable. For this reason, Aurora believes that transmission charges related to NICs should be categorised as pass-through Costs (not Recoverable Costs as proposed in the Draft Reasons Paper).

3. Other Potential Amendments to Take into Account Input Methodologies

The *Refinements Paper* notes that the Commission intends to amend the DPP determination to reflect the relevant application of Input Methodologies and appropriate definitions, following their determination by the Commission. The *Refinements Paper* discusses potential amendments to the DPP to reflect:

- the specification of applicable Input Methodologies;
- the application window for a CPP;
- the implications of EDB merger and acquisition transactions; and
- the circumstances in which the DPP may be reconsidered.

Aurora's Comment

Aurora supports, in principle, the Commission's proposals to amend the DPP in this regard. However, Aurora notes that Input Methodologies have not yet been finalised, and these proposals have not been considered in any detail.

4. Adjusting CPI for the 1 October 2010 Increase in GST

On 1 October 2010 the GST rate will increase from 12.5% to 15% under tax reforms announced by the New Zealand Government. As the impost of GST is 'passed through' to final consumers, the GST increases will have an impact on consumer inflation (CPI), but are unlikely to have any material impact on an EDB's cost structure. The Commission is concerned that the impact of GST increases on the CPI, where EDBs can increase prices by CPI-X, will give rise to windfall gains by EDBs. The *Refinements Paper* proposes an adjustment to the actual consumer price index (CPI) to remove the impact of the GST increase.

¹² Supra, Note 8, para 14

Aurora's Comment

Aurora supports amending the DPP to clarify that posted prices are prices exclusive of GST. However, Aurora does not support scaling the CPI values in the compliance assessment formula by 1.02 (the Reserve Bank having estimated a 2% impact on the CPI from the GST increase) as also proposed by the Commission¹³. Aurora's rationale for this view is as follows:

- ◆ the Commission will be reducing real returns to existing capital

The Commission is wrong to surmise that all of the costs that are recovered through an EDB's prices are immune to GST. For instance, cost recovery under a traditional 'building blocks' approach suggests a distinction between operating and capital costs. With respect to capital costs the Commerce Commission has adopted the principle of financial capital maintenance (FCM). Under FCM, the Commission seeks to maintain the value of an EDB's capital in real terms. In this regard, Aurora notes the Commission's GST/CPI proposals will result in a reduction of the real financial capital of EDBs.

- ◆ the CPI was never intended to be exact in measuring changes in an EDB's input costs

Aurora accepts that a case for over-recovery could be made in relation to the recovery of operating expenditure under a CPI-X price path (following the increase in GST). However, in setting the DPP, both the Commission and EDBs accepted that the CPI was a reasonable, but not exact, proxy for changes in an EDB's input costs. In fact, previous evidence on this issue that EDBs presented to the Commission, suggested that the CPI understated the changes in an EDB's labour and capital costs. Aurora also notes that s53O(b) requires the rate of change (X-factor) to be set relative to the CPI.

Aurora believes it is wrong, and opportunistic, for the Commission to seek to adjust the CPI for a change that affects the index, but (possibly) has little direct impact on EDB costs. In this regard, Aurora notes:

- GST increases may have a flow on effect to Aurora's profitability if consumers reduce demand for electricity, and/or higher consumer prices translate into higher labour costs; and
 - other factors affecting the CPI (e.g. positive/negative oil price shocks, seasonal fruit prices) have little direct impact on EDB costs ... but the Commission does not propose adjustments for these impacts.
- ◆ the GST increase may result in immaterial increases in profitability but not windfall gains

To the extent that the GST increase results in a CPI-X cost recovery that exceeds the increase in an EDBs input costs, Aurora notes that the over-recovery will be small (i.e. considerably smaller than the 2% estimate used by the Commission), and it will be a one-off occurrence. This cannot be regarded as giving rise to a windfall gain. Further, the cost of trying to separate out the capital vs. operating cost impact on EDBs, and then adjust the compliance assessment formula, is unlikely to be worth the Commission's effort.

¹³ see *Refinements Paper* paras 3.38 to 3.41 (particularly paras 3.39 and 3.41)

- ◆ such changes to the DPP are inconsistent with the statutory framework

A feature of the regulatory/statutory framework is that the Commission cannot adjust the DPP at its discretion. Amendments to a s52P determination (DPP) may only be made in accordance with:

- s52Q (following consultation), s53ZB (following a changed Input Methodology);
- s54K(3) (following the initial determination of Input Methodologies); or
- an Input Methodology specifying the circumstances in which a DPP can be reconsidered in a regulatory period (s52T(1)(c)(ii)). Aurora notes that the Commission's draft Input Methodology on reconsidering the DPP would not cover the GST/CPI circumstances at issue here.

The DPP is intended to represent low cost regulation, and in this regard the DPP is not intended to account for every eventuality. If an 'eventuality' were to impact adversely on an EDB, a CPP (amongst other things) is available to that EDB. However, if the 'eventuality' were to impact favourably on the EDB, the legislation makes it clear that past excessive profits (if any) are out-of-bounds for the Commission.

In short, Aurora believes that the Commission is acting opportunistically to propose an adjustment to the compliance assessment formula for the impact of GST on the CPI. This opportunity only exists pursuant to s54K(3) as Input Methodologies are currently being determined, and as a consequence, the s52P DPP may be redetermined (in accordance with s53P).

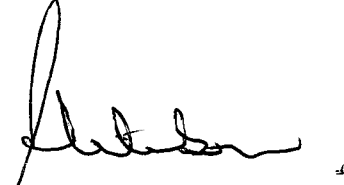
54K Section 52P determinations setting out default price-quality paths applying from 1 April 2010

- (1) *Before 1 April 2010, the Commission must reset the default price-quality paths for each supplier that apply on and after that date, using the process set out in section 53P.*
- (2) ...
- (3) *If an input methodology is published after 1 April 2010 and if, had that methodology applied at the time the default price-quality paths were reset as required by subsection (1), it would have resulted in a materially different path being set, then the Commission may reset the default price-quality paths in accordance with section 53P ...*

However, as explained above by Aurora, there is no (material) basis for the Commission to make such an adjustment.

Aurora appreciates the opportunity to make this brief submission, and looks forward to engaging with the Commission as these, and other, proposals for refining the DPP are advanced. In particular, Aurora awaits the Commission's proposals on the integration of price and quality. Should you have any questions in relation to the above, please do not hesitate to contact Lindsay McLennan (phone 03 479 6669).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Stephen Wilson', with a stylized flourish at the end.

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