

**Submission to the Commerce Commission**

**on the**

**Default Price-Quality Path Refinements  
Discussion and Draft Decisions Paper**

**Made on Behalf of  
18 Electricity Distribution Businesses**

**27 September 2010**

## Submission on Default Price-Quality Path Refinements Discussion and Draft Decisions Paper

This paper forms our submission on the Commerce Commission's (the Commission's) 2010-2015 Electricity Distribution Default Price-Quality Path Refinements Discussion and Draft Decisions Paper (the Refinements Paper), which has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 18 Electricity Distribution Businesses (EDBs):

- Alpine Energy Limited
- Buller Electricity Limited
- Counties Power Limited
- Eastland Network Limited
- Electricity Ashburton Limited
- Electricity Invercargill Limited
- Horizon Energy Distribution Limited
- MainPower New Zealand Limited
- Marlborough Lines Limited
- Nelson Electricity Limited
- Network Tasman Limited
- Network Waitaki Limited
- Northpower Limited
- OtagoNet Joint Venture
- The Lines Company Limited
- The Power Company Limited
- Top Energy Limited
- Westpower Limited.

### Background

1. On 30 November 2009 the Commission published a Section 52P determination on the default price-quality path for EDBs – referred to as the Initial Reset Determination. The default price-quality path (DPP) under the Initial Reset Determination applies from 1 April 2010 until 31 March 2015 and is now referred to as the 2010-2015 DPP.<sup>1</sup>

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<sup>1</sup> Previously it was referred to as the Reset DPP.

2. In its DPP Decisions Paper,<sup>2</sup> the Commission indicated that further work would be undertaken on the DPP and that once this work was complete that the Commission intended to amend the DPP determination accordingly. Included in the additional work was recognition that the Commission is currently consulting on input methodologies (IMs) in accordance with Section 52T of the Act, and that some of those IMs would be integrated into the DPP. Although the IM consultation process has not yet finished, and IM determinations are yet to be made, the Refinements Paper considers how the draft IMs (consistent with the Commission's Draft Reasons Paper and associated draft determinations)<sup>3</sup> could be integrated into the DPP. It also considers other related issues such as amendments to the CPI index and the timing of the potential changes to the DPP.
3. In addition, the DPP Decisions Paper also indicated that the 'revenue adjustment term' proposed by submitters would be considered further by the Commission with a view to introducing it in December 2010, prior to the second DPP assessment period. The Refinements Paper includes recommendations arising from the Commission's further assessment of this term.
4. Other issues which were also to be considered further include starting price adjustments, dedicated energy efficiency mechanisms, quality incentives, enforcement guidelines and avoided transmission charges in the event of a transfer of assets between Transpower and an EDB. With the exception of starting price adjustments (addressed in the 5 August Discussion Paper)<sup>4</sup> and avoided transmission charges (addressed in the IM draft determinations) there has been no further consultation on the other issues to date.
5. We are particularly concerned that the Commission has not yet made any progress on the Enforcement Guidelines, particularly as we are now almost half way through the first assessment period of the 2010 – 2015 DPP. In the 3 May Update Paper the Commission acknowledged requests for more detail on this work stream and indicated that a consultation timetable would be released shortly.<sup>5</sup> This has not yet eventuated. We have previously submitted that this is required with some urgency, as the consequences of breaching the

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<sup>2</sup> Commerce Commission, Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses, Decisions Paper, 30 November 2009

<sup>3</sup> Commerce Commission, Input Methodologies Electricity Distribution Services, Draft Reasons Paper, 18 June 2010 and Commerce Commission, Input Methodologies, Companion Paper and Draft Determinations, 2 July 2010

<sup>4</sup> Commerce Commission, Starting Price Adjustments for Default Price-Quality Paths, Discussion Paper, 5 August 2010

<sup>5</sup> Commerce Commission, Further Work on the Reset Default Price-quality Path for Electricity Distribution Businesses, Updated Process Paper, 3 May 2010

DPP are potentially more severe than under the Part 4A thresholds regime, and businesses need to understand these consequences. This is consistent with the regulatory certainty objectives of the 2008 Commerce Act amendments.

6. In the following paragraphs we address the revenue adjustment term and IM amendments to the DPP as proposed in the Refinements Paper.

#### **Revenue Adjustment Term**

7. In our 2009 submissions on the draft DPP we proposed a revenue adjustment term to correct an error in the Commission's proposed price path formula which in effect reset the price path each year based on the previous year's actual prices.<sup>6</sup> We submitted that this was inconsistent with the intention of the price path and our proposed adjustment term was required to ensure that any differences between Allowable Notional Revenue and Notional Revenue in any one assessment period did not increase or reduce the price path in subsequent assessment periods.
8. The Refinements Paper now proposes that this term is included in the DPP with the amendment to be made before 1 December 2010, so that it will take effect from 1 April 2011. We support this proposal, and note that it is consistent with the draft Processes and Rules IM which provides for reconsideration of the DPP for the purpose of correcting errors.
9. We note that EDBs have from time to time inadvertently breached the price path threshold. This is likely to occur under the DPP, although it is expected that changes introduced into the DPP will reduce the number of technical breaches and the potential magnitude of them. One of the characteristics of these technical breaches is that EDBs have sought to remedy the breach in the following assessment period(s). The Commission has taken remedial action into consideration when assessing the breach, which has resulted in a cost effective process for resolving such breaches. We submit that a similar process should form part of the Commission's evaluation process under the DPP, and the planned Enforcement Guidelines should set out a mechanism for recognising remedial action undertaken by an EDB to compensate for a technical or inadvertent breach.

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<sup>6</sup> For example, PwC Submission on Behalf of 18 EDBs, Initial Reset of the DPP for EDBs, Draft Determination, 3 November 2009, paragraph 19

## Input Methodologies

10. We have recently responded to the draft IMs in a series of submissions made during August. The Commission is to now consider the submissions received before finalising the IMs. Further draft determinations reflecting the Commission's final decisions are to be issued for technical drafting consultation later this year, prior to the final determinations being made. These must be gazetted by 31 December 2010.
11. Chapter 3 of the Refinements Paper identifies those components of the IMs which are relevant for the DPP and sets out how each of these are proposed to be integrated into the DPP. This discussion is based on the draft IMs as set out in the 18 June Draft Reasons Paper. The discussion and proposed refinements to the DPP therefore reflect the Commission's views on the IMs, prior to consideration of the view of interested parties as expressed in the August 2010 submissions.
12. Responding to the Refinements Paper is therefore somewhat frustrating for those parties which have invested considerable effort in considering the draft IMs and preparing submissions which propose alternatives to the Commission's draft decisions. This consultation could have been more usefully delayed until after the IM decisions have been made. As it stands, it is likely that Chapter 3 of the Refinements Paper will need to be revised and reissued after the submissions from interested parties have been fully considered and final IMs have been determined before any changes to the DPP arising from the IM determinations can be considered. In the following paragraphs we comment on each of the proposals for amendments to the DPP arising from the draft IMs. Our comments are consistent with our August 2010 submissions on the draft IMs.

### *Specification of Price*

13. We have previously submitted on and supported the use of a weighted average price cap for the purposes of the DPP and CPP.<sup>7</sup> This is already encapsulated in the DPP and therefore if a weighted average price cap is adopted in the Processes and Rules IM it would require no change to the DPP.

### *Pass-through and Recoverable Costs*

14. The DPP determination issued in November 2009 includes as pass through costs transmission costs, avoided transmission charges, Electricity Commission and Commerce Commission levies and local body rates. Our IM submission supports this approach.<sup>8</sup> In the

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<sup>7</sup> PwC Submission 1, IMs for Electricity Distribution Services, 9 August 2010, paragraph 67

<sup>8</sup> Ibid, paragraph 69

draft Processes and Rules IM however the Commission sets out a modified view of pass through costs and includes a new category of costs: 'recoverable costs'. If these were to be introduced they would reverse the 2010-2015 DPP determination in respect of pass through costs. As these were consulted upon and finalised late last year, this is somewhat surprising and it is not clear why the Commission has changed its view so soon after the initial determination.

15. The Refinements Paper sets out in some detail proposals to replace the pass through cost provisions for transmission and avoided transmission charges, with provisions for recoverable costs. Our submission on the draft Processes and Rules IM did not support this change. In particular we noted that suppliers need certainty in order to make investments in transmission alternatives, or enter into agreements with Transpower for new connection assets. These are long term investments and EDBs must be able to recover the costs of these in full from consumers. The proposed recoverable cost category does not provide this certainty.
16. In our submission we also noted that the Commission's proposals for avoided transmission excluded provision for the recovery of avoided transmission charges paid to distributed generators.<sup>9</sup> Such payments are made under contract to distributed generators and are governed by the Electricity Distributed Generation Regulations 2007. They should be included as pass through costs, consistent with the existing DPP and the treatment of other transmission related charges. It is not clear why this change is included in the IM, as it is inconsistent with the 2010 – 2015 DPP, and is not addressed in the Refinements Paper.
17. The discussion in the Refinements Paper however refers to another category of avoided transmission charges, where an EDB may make an investment which substitutes for the transmission grid. Our IM submission supports this proposal.<sup>10</sup> We also supported it in our submissions on the DPP determination in 2009 however it was not accepted by the Commission at that time.<sup>11</sup> Accordingly we support the proposed provisions for incentives for investment in grid substitutes, which is consistent with our submissions on the DPP made last year.

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<sup>9</sup> Ibid, paragraph 79

<sup>10</sup> Ibid, paragraph 78

<sup>11</sup> Supra n6, paragraph 36 and Appendix A

*CPP Application Window*

18. It is proposed that the CPP application window will be specified in the DPP. It is important that the full CPP process is set out clearly in the CPP IM and suppliers must be able to predict the outcomes when making a CPP proposal. This includes how an application is to be made, assessed, determined, re-determined and concluded (ie: the transition from a CPP to a DPP). The interface with the DPP therefore occurs at the start and the end of a CPP. We agree that the relevant provisions in the CPP IM could therefore usefully be replicated in the DPP, with reference to the CPP IM where relevant, however we do not believe this is a necessity.

*Transactions between EDBs*

19. Similar to the CPP application window issue above, the DPP must be consistent with the IMs where they are relevant to the DPP. The provisions for transactions for EDBs under the DPP are addressed in the Processes and Rules IM. The existing DPP includes specific provisions for transactions between EDBs in Clause 10. If these provisions are inconsistent with the IM, they will need to be changed if they are materially different to the IM. If not, further changes may be deferred until 2015.
20. The draft IM also suggests that a rolling incentive scheme (IRIS) could be introduced under a CPP to provide incentives for suppliers to retain the benefits of efficiency gains after a transaction for a period of five years. A transition of IRIS into the DPP would be required for EDBs moving from a CPP to the DPP. Our submission on this IM was that five years was not long enough for such incentives to be effective and that this should be extended to ten years. In addition we submitted that an IRIS mechanism could be, and should be introduced into the DPP.<sup>12</sup>

*Reconsideration of the DPP*

21. The draft Processes and Rules IM also sets out the proposed criteria under which a DPP may be reconsidered. Once finalised this will be included in the IM determination. The same provisions can be included in the DPP determination itself.
22. Our submission on the Processes and Rules IM did not support the draft provisions for reopeners. In particular we submitted that DPPs should be reopened in response to:
- an error in the determination;
  - misleading information used in making the determination; and

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<sup>12</sup> Supra n7, paragraphs 87-89

- catastrophic events.<sup>13</sup>

*Process for IM Amendments*

23. The Refinements Paper proposes that the changes in the IMs which impact on the price path component of the DPP should be introduced after the beginning of the second assessment period (1 April 2011), but before 1 December 2011, so that they would be known at the time EDBs set their prices for the assessment period commencing 1 April 2012. Amendments could not be made prior to 1 April 2011 as they would not be able to be incorporated into prices for that period unless the IMs were determined before 30 November 2010 and the DPP determination amended by that date.
24. The Refinements Paper however suggests that other amendments which would not impact on the price path (such as the CPP window) could be made at any time, possibly prior to 1 April 2011. We note that Sections 54K(3) and 54K(4) of the Act set out the processes by which the Commission may amend the 2010 – 2015 DPP following the 2010 IM determinations. In particular Section 54K(3) requires the IM to result in a materially different path and Section 54K(4) requires the changes to be made within 9 months of the publication of the IMs. It is not clear to us why the Refinements Paper does not refer to these provisions.
25. Accordingly, we submit that the Commission has a limited window in which to make the amendments to the DPP arising from the IMs and it may only make these if they result in a materially different DPP outcome. We agree with the proposition in the Refinements Paper that those elements of the IMs which may impact on the price path component of the DPP should not be introduced before 1 April 2011 (as EDBs would not be able to adjust prices accordingly). Under Section 54K(4), they must however be introduced within nine months of the IM determination (ie: at the latest by 30 September 2011).
26. We also note that Section 54K(3) imposes a ‘materially different’ test on amendments to the DPP arising from IM determinations. We suggest the Commission considers this further once the IMs have been finalised, before changes are introduced into the DPP. It is inevitable that the Commission will need to re-consult on the relationship between the 2010 IMs and the DPP once the final 2010 IM determinations have been made. It is also possible that some of the proposed changes may not meet the materially different test and may need to be deferred until the 2015 reset.

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<sup>13</sup> Ibid, paragraphs 80-86

27. In conclusion, with respect to the IMs which potentially impact on the DPP we note:

- The proposed specification of price as a weighted average price cap is consistent with the existing DPP and is supported;
- The proposed specification of pass through costs and recoverable costs is not supported however the proposed amendment to the definition of avoided transmission charges to provide incentives for investments which substitute for the transmission grid is supported;
- The omission of avoided transmission payments to distributed generators from pass through costs is not supported;
- We have submitted that pass-through costs should also be extended to include costs not provided for in the DPP including those which arise from new legislation or regulation and those which arise from catastrophic events;
- The proposal for the IRIS carry over mechanism when transitioning from a CPP to a DPP is supported, however we have submitted that this should apply for a period of ten years not five, and that a similar scheme should be implemented under the DPP;
- The interface between the DPP and the CPP (at the time an EDB steps into and out of a CPP) should be included in the CPP IM, and duplicate provisions may be included in the DPP;
- If provisions for EDBs which transact in the IM differ to those in the DPP, then the DPP provisions should be changed to be consistent with the IM; and
- Where reconsideration provisions relating to the DPP are included in the IMs, consistent provisions may usefully be included in the DPP.

**Amendment to the Derivation of CPI**

28. The Refinements Paper also proposes an additional change to the DPP which does not arise from an IM, nor is it a correction to the DPP. The proposed change is to alter the definition of the CPI index to apply to the price path component of the DPP. The Refinements Paper does not set out the legislative basis on which the Commission may make such a change. The CPI index to be used in the DPP is not covered by an IM however section 53O(b) states that the DPP must include ‘the rate or rates of change in prices, relative to the consumer price index, allowed during the first regulatory period’. The DPP determination was consulted upon and finalised last year, which included in the DPP provision for indexation of the price path over the DPP period using a CPI-X mechanism. The CPI included in the DPP determination is defined as the Statistics New Zealand All Groups Index SE9A, consistent with section 53O(b). The Refinements Paper now proposes to modify the index to be used.

29. We do not support this proposed change to the DPP. It does not fall within the definition of a reopener as set out in the draft IM, nor is it an IM itself. It is also contrary to section 53O(b). There does not therefore appear to be provision in the Act for this change to be made.

30. We also note and support the ENA's submission which objected to the proposal for a similar change to be made to the CPI index to be used in a CPP.<sup>14</sup> The proposed change to the CPI index to be used is opportunist and is inconsistent with the rationale for using the CPI. It is therefore counter to good regulatory practice. We also endorse the ENA's submission that the CPI is not intended to measure input cost inflation for EDBs, as it is a general inflationary index which is used to assess economy wide inflation. It is influenced by many factors including taxation. General inflation indices are widely used by regulators to enable the assessment of regulated returns in real terms. We do not therefore support the Commission's proposal to change its previous determination in response to a factor which has occurred after the determination was made, which is not consistent with the reopener provisions in the draft Processes and Rules IM and which is inconsistent with the regulatory objectives for indexation. In addition, as the proposed change does not form part of an IM, the Section 54K provisions do not apply in this instance.
31. If as a consequence of the change in GST rate, EDBs increase their profitability during the 2010-2015 DPP, the 2015 DPP reset process is designed to assess profitability at that time and make adjustments to starting prices if necessary. This is the way in which the DPP has been designed to operate and is consistent with the relevant provisions in the Act.

## Other Issues

### *Avoided transmission payments to distributed generators*

32. One of the issues discussed at length during the 2009 consultations on the DPP was the ability of EDBs to forecast their DPP performance when setting prices for the forthcoming year, and a desire to avoid technical breaches based on forecasting error where possible. Changes were introduced to the price path and the quality path relative to the 2004 – 2010 thresholds in order to reduce the likelihood and materiality of forecasting breaches.
33. One of the sources of forecasting error under the thresholds was in respect of pass through costs, where actual pass through costs were used in the annual price path threshold compliance assessment, however prices were set on the basis of forecast pass through costs. Recent changes in the transmission pricing methodology as well as the exclusion of loss rental rebates from pass through costs under the DPP now mean that transmission charges are more predictable for the purpose of the DPP and technical breaches less likely.

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<sup>14</sup> ENA, Submission 9, CPP IM, pages 30-32

The rates and levy components of the pass through costs are not material and therefore unlikely to be the primary reason for a technical breach.

34. It has recently come to our attention however that the manner in which EDBs contract with distributed generators for avoided transmission charges means that at the time prices are set for the forthcoming year, it is not possible to predict the avoided transmission charges that will be made to distributed generators. This is because the avoided transmission charges are influenced by the provision of distributed generation during the regional peak demand periods which are used in the transmission pricing methodology. As these are released on a 1 September – 31 August basis, they do not align with the EDB pricing period or DPP assessment period.
35. For many EDBs this issue is not material but for a small number of EDBs it is significant, and is likely to increase as more distributed generation is commissioned across the country, particularly in rural areas.
36. Accordingly, it is likely that the avoided transmission component of pass through costs may result in technical breaches of the DPP for some EDBs. We suggest the Commission considers this issue and addresses it in the planned Enforcement Guidelines. Another possible remedy would be to lag this component of avoided transmission by one year in the DPP formula, which is a refinement which could possibly be considered at the next reset in 2015. This change would not meet the criteria for reopeners for the 2010 – 2015 DPP.

*Transpower pricing for 2011*

37. We refer to the recent consultation paper on the process for setting individual price quality regulation (IPP) for Transpower.<sup>15</sup> It has been brought to our attention that the revised process in respect of the IPP determination which will take effect on 1 April 2011 is that draft determinations will be made in November 2010 with final determinations in December 2010. This is a one month deferral of the earlier timetable which had the final determination by 30 November 2010. The primary reason for the deferral is that it allows the Commission to align the final IM determinations for Transpower with the IPP determination.
38. As the IPP is to apply to Transpower from 1 April 2011, the deferred determination date conflicts with the four month notification period provided for in Section 53M(7) of the Commerce Act. It is proposed that Section 53ZC is used to permit the change.

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<sup>15</sup> Commerce Commission, Individual Price-Quality Regulation of Transpower, Revised Process Paper, 26 August 2010

39. Paragraphs 1.12 – 1.13 of the process paper consider the impact of the deferral and conclude that the deferral will have no impact on Transpower or interested parties as there will be a wash up at the end of the transition year to account for any differences between the draft and final determinations which will be dealt with through Transpower's economic value accounts. From an EDB perspective we note that it is imperative that EDBs receive their transmission pricing notifications at least four months prior to the commencement of each DPP assessment period (ie: four months prior to 1 April 2011).

**General**

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