

Submission on DPP Starting Price Adjustments and Other DPP Amendments

From the Electricity Networks Association

16 May 2011

Electricity distribution businesses (EDBs) supporting this submission

The Electricity Networks Association makes this submission along with the explicit support of its non-exempt EDB members listed below.

Alpine Energy Ltd
Aurora Energy Ltd
Centralines Ltd
Eastland Network Ltd
Electricity Ashburton Ltd
Electricity Invercargill Ltd
Horizon Energy Distribution Ltd
Nelson Electricity Ltd
Network Tasman Ltd
OtagoNet Joint Venture
Powerco Ltd
The Lines Company Ltd
Top Energy Ltd
Unison Networks Ltd
Vector Ltd
Wellington Electricity Lines Ltd

Orion New Zealand Ltd, due to its current difficult circumstances, has been unable to focus on this submission sufficient to confirm or otherwise its support for it.

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Executive summary

1. The Electricity Networks Association (ENA) welcomes the opportunity to submit on the Commerce Commission's (Commission) paper, issued in April, on the method to adjust default price-quality path (DPP) starting prices for non-exempt electricity distribution business (EDBs).
2. Over the last two years the Commission and the sector have made a large investment in the development of regulatory input methodologies (IMs), which are designed to improve the certainty of price-quality regulation. The method to adjust DPP starting prices is the Commission's first opportunity in this sector to apply the IMs. The April paper, unfortunately, has generated a great deal of uncertainty in the sector as it puts forward, late in the process, a very different method for adjusting starting prices than that developed in two previous Commission papers over the last two years. In this submission the ENA recommends a method for adjusting starting prices that builds on its previous submissions on this topic and takes into account the very limited data the Commission has available to it, at this time, to undertake this task.

Concerns with the proposed method

3. The ENA has three high level concerns with the design of the proposed method for adjusting DPP starting prices:
 - First, it uses reported return on investment (ROIs) from a single year (2009/10) to estimate commencing ROIs in its model, with no tolerance for error that reliance on a single year can be expected to result in. This is despite the Commission itself, in its two previous papers, and its adviser Economic Insights, identifying the risks of placing too much reliance on one year's data.
 - Second, the proposed method incorporates a forecast of ROIs over the regulatory period. While we appreciate that the Commission has responded to submitters' views that the Commission should take account of projected profitability, we are concerned that the Commission has not developed robust estimates of the key input parameters. Further work must be undertaken to establish and test whether the input parameters are robust. In this submission we propose an alternative method of using projected profitability which in our view better recognises the uncertainties associated with the Commission's proposed approach and data limitations.
 - Third, the Commission makes judgements in relation to the design of its proposed starting price adjustment method in the belief that a customised price-quality path (CPP) is a low cost and ready means available to EDBs to correct any errors arising from the method. The ENA considers the Commission is mistaken in this belief. The CPP was never designed to be a readily accessible error correction mechanism for DPP starting price

adjustments, and from an EDB's perspective the CPP option in the IMs is much too costly and risky to be such a mechanism.

4. Other ENA concerns with the proposed method are:
 - It does not achieve the purpose of Part 4 and the purpose of default/customised price-quality paths, by rendering CPPs to an error correction mechanism. CPPs are intended to be used by exception, for example to meet a substantially increased capital expenditure requirement.
 - The use of industry-wide assumptions in the forecasting component of the method does not result, in any meaningful way, in an estimate of the current and projected profitability of *each supplier*.

Recommended modifications to the proposed method

5. The ENA recommends the following modifications to the proposed method, which take into account that the useable dataset available to the Commission at this time is severely limited:
 - That 2009/10 ROIs, prepared on the basis of the IMs, be used as the estimate for current and projected profitability for each EDB.
 - That the 2009/10 disclosed values be rolled forward to project a 2010/11 ROI, and that starting prices as at 1 April 2010 be adjusted such that the projected ROI for each EDB in this year equals the Commission's estimate of (so called 75th percentile) WACC plus at least one standard deviation of the ROI series as assessed in the Thomson/van Zijl report.
 - That the resulting adjustment in starting prices as at 1 April 2010 be rolled forward to 1 April 2012 using the DPP Determination calculations, in order to reflect this adjustment in Allowable Notional Revenue for each EDB for the year commencing April 2012.
6. The logic for this approach is as follows:
 - The 2009/10 ROI is the best estimate the Commission has of the current and projected profitability of each supplier. The absence, at this point in time, of a data series and a robust method to undertake forecasts of these reported ROI values means any attempt at doing so can be expected to add, rather than reduce error in this estimate (and by implication would require an even wider margin for error than that identified in the Thomson/van Zijl report).
 - Consistency with the purpose statement requires the Commission to use a method for adjusting DPP starting prices that promotes outcomes in which each EDB can expect to earn at least its WACC, given the evidence available to the Commission, while retaining a low-cost approach.

- In order for the Commission to have confidence (in a statistical sense) that any starting price adjustment is consistent with the purpose statement it needs to take account of the potential for Type One errors (or false positives) - that is where starting prices are set at a level that does not enable an EDB to expect to earn at least a WACC return.
 - The Thomson/van Zijl report provides the best estimate available of the dispersion of EDB ROIs over time. The calculation of ROIs using the IMs may change their absolute level but is unlikely to change their variability significantly, and therefore these estimates remain relevant.
 - This estimate of the dispersion of EDB ROIs enables the Commission to calibrate its method to ensure it has a specified level of confidence in the results in terms of false positives. Adding one standard deviation of the ROI dispersion to WACC would result in the probability of 15.87% for false positives, and adding two standard deviations would result in a probability of 2.28%.
 - The ENA has previously recommended this false positive rate be set at 2.28% (i.e. that two standard deviations be used). The Commission disagreed with this view, but when doing so incorrectly conflated this issue with uncertainty related to the estimation of WACC. The ENA remains of the view that the Commission is obliged to take account of the evidence before it on the dispersion of EDBs' ROIs and the implications of that dispersion for uncertainty in its decision making. The ENA considers, at a minimum, at least one standard deviation needs to be allowed for in these circumstances (for reasons of asymmetrical economic effects of error, the costs and risks associated with a CPP, and the requirements of the purpose statement).
7. The ENA has submitted a modified Commission spreadsheet model that illustrates these recommended changes, leaving the Commission's model unchanged in all other respects (and for illustration uses the standard deviation values from the Local Level model in the Thomson/van Zijl report). The results of these changes are presented as "Step One", in the new sheet "Projected Profitability Revised", and are coloured green, and the width of the margins for error can be configured from the new sheet "Error Margins".

Possible use of forecasts

8. The Commission's proposed method also includes a forecasting component. While we recognise that the Commission has developed this approach in light of earlier submissions, we are concerned that the development of the key input parameters falls short of the degree of robustness necessary to ensure that DPP paths can be expected to reliably provide EDBs with sufficient earnings to cover their WACC. The ENA considers this component, given the very limited data available at this time and the use of industry-wide (rather than EDB specific) assumptions, would be best used as a check on the drift in ROIs over the regulatory period. This check could be undertaken as follows:

- Once initial price adjustments have been calculated as described above, the ROIs for each EDB are forecast for the regulatory period.
 - For those EDBs whose forecast ROIs do not drift outside of a band set with WACC as the lower bound, and plus two standard deviations of ROI dispersion to provide the upper bound, no further price adjustments are made. The use of two standard deviations in this case reflects the greater level of uncertainty introduced by the forecasting method and the assumptions used in those forecasts.
 - For those EDBs whose forecast ROIs drift above or below the boundaries of the band over the five year period (or three year period if that is used), their starting prices are adjusted by an amount to reflect the present value (PV) of earnings that is represented in the forecast ROIs exceeding, or moving below, the boundaries of the band.
9. This forecasting extension is incorporated as “Step Two” in the spreadsheet model attached to this submission, and the results from applying it are presented in the new sheet “Projected Profitability Revised”.

Other proposed amendments to the DPP

10. The April paper recommends a number of other amendments to the DPP. In general the ENA supports these amendments, but for:
- The avoided transmission charges that can be treated as recoverable costs for five years (subsequent to purchasing transmission assets from Transpower) should be able to be calculated as the charges avoided in each of these five years and not have to be approximated by the charges avoided in the first year.
 - The ENA disagrees that the definition of the CPI in the DPP should be changed.
 - The need for clarity in the way in which amalgamations are included in the merger and acquisition provisions of the DPP.

1. Introduction

11. This submission from the Electricity Networks Association is in response to the Commerce Commission's (Commission) paper of 11 April on DPP starting price adjustments and other amendments to the DPP (2011 SPA Paper).
12. The 2011 SPA Paper is the third the Commission has issued on a possible method for undertaking starting price adjustments. The former papers were issued in June 2009 (2009 SPA Paper) and August 2010 (2010 SPA paper)¹ and the ENA has provided responses to each of these.
13. In this submission we consider the legal and wider context of any DPP starting price adjustments, and respond to the Commission's proposed new method for undertaking such adjustments. The submission is structured along the following lines:
 - Section 2 outlines the context for these possible DPP starting price adjustments and provides a high level critique of the Commission's proposed method.
 - Section 3 sets out the legal framework for DPP starting price adjustments and the implications of that framework for the method proposed in the 2011 SPA Paper and for possible improvements to it.
 - Section 4 assesses the method proposed in the 2011 SPA Paper for estimating the ROI of each supplier at the commencement of the regulatory period and forecasting ROIs throughout the period, and recommends possible improvements to that method.
 - Section 5 recommends modifications to the Commission's proposed method for determining the extent of any starting price adjustments.
 - Section 6 considers the other DPP amendments proposed in the 2011 SPA Paper and possible improvements to them.
14. The ENA has submitted previously, and continues to hold the view that the method for adjusting DPP starting prices should be determined by the Commission as an IM.² This submission does not reiterate the arguments for

¹ *Reset of default price-quality path for electricity distribution businesses; Discussion paper*; Commerce Commission, 19 June 2009, and *Starting price adjustments for default price-quality paths; Discussion paper*; Commerce Commission, 5 August 2010

² The reasons for this view are set out in the ENA letter of 23 July 2010 headed *Starting price adjustment methodology*

this view but the ENA considers the method proposed in this submission to adjust DPP starting prices could, and should be articulated as an IM.

2. Context and overview of proposed method

15. When resetting the DPP to apply for the period April 2010 – March 2015, the Commission in 2009 decided to defer any adjustments to DPP starting prices until after it had determined and published the IMs applying to EDBs. Those IMs were published in January 2011.
16. The Commerce Act 1986 (the Act) allows the Commission, as a one-off transitional measure, to reset the DPP once the IMs are published (see s 54k), provided that:
 - had the IMs applied at the time the default price-quality paths were reset in 2009, they would have resulted in a materially different path being set; and
 - the Commission undertakes the reset (i.e. exercises its powers) no later than 9 months after publication of the IMs (which was 20 January, giving the Commission until 20 October to complete this task).
17. The Commission's proposed method to adjust DPP starting prices comprises three broad steps:
 1. It identifies an EDB's "initial conditions" with reference to a single year, 2009/10. These initial conditions include ROI, the components that make up ROI, and the level of commissioned assets in that year.
 2. It applies industry-wide estimates of three variables (real revenue growth, nominal opex growth, and nominal capex growth), and an economy-wide estimate of CPI, to the initial conditions of each EDB to create a forecast of each EDB's business over the regulatory period.
 3. It identifies the extent to which starting prices would need to be adjusted in order for the forecast internal rate of return (IRR) for each EDB over the regulatory period to equal the Commission's estimate of an EDB's WACC.
18. The ENA has three primary concerns with this method. The first is the method uses reported performance from a single year, with no attempt to test whether that year is representative of the business, and with no tolerance for error that reliance on a single year can be expected to result in. Any aberrations incorporated in the reported results of the 2009/10 year are carried forward in the forecasts of ROIs.

19. The Commission has raised concerns in its previous papers about placing undue reliance on one year's data³ and its adviser Economic Insights⁴ raises the same point in its critique of the Thomson/van Zijl paper.⁵ This issue is discussed in sections 4 and 5 and we recommend a way to mitigate this weakness by introducing a margin for error, derived from the statistical analysis in the Thomson/van Zijl report.
20. The second is the difficulty inherent in producing forecasts of an EDB's business over the regulatory period, while retaining the relatively low cost approach required of the DPP regime. The Commission has recognised in its previous papers the difficulties of undertaking such forecasts in the DPP context and for that reason its previous proposed methods did not incorporate forecasts of ROI.⁶
21. In the 2011 SPA Paper the Commission incorporates a forecasting component for the first time. While the ENA wishes to acknowledge the Commission's attempt to include a forward looking aspect to the starting price adjustment method, we consider the proposed forecasting component falls well short of the robustness required for the important task of determining adjustments to starting prices. The historical data are not available to provide the basis for credible trend analysis at the individual EDB level (which is the level at which prices are set), and the method proposed by the Commission is ad hoc and does not have

³ For example, in paragraph 240 of the 2009 SPA Paper the Commission states "*Finally, it is important to recognise that how meaningful the comparison of the ROIs with the WACC is to assess profitability, will crucially depend on such things as the length of the period and size of the data sample over which any comparison is made. As the ROI for a firm can vary significantly from year to year – due to random stochastic variations – it may be very difficult to infer excessive profits when there is only a small data sample available.*"; and in paragraph 4.4 of the 2010 SPA Paper "*When undertaking starting price adjustments, the ROI formula and data required to compute ROI statistics for the latest year only represents a partial picture of a supplier's profitability. Annual ROI statistics can exhibit year-on-year variations that may or may not reflect actual changes in the supplier's returns.*"

⁴ See comments that a weighting of 73% on a single year's data is considered too great, and open to gaming, on page ii of *Review of statistical analysis of starting price adjustments*, Tim Coelli & Denis Lawrence of Economic Insights, 5 April 2011

⁵ *A statistical forecasting framework for the determination of starting price adjustments for default price-quality paths: A report undertaken for the Electricity Networks Association*, Peter Thomson & Tony van Zijl, 8 December 2010

⁶ In the 2009 SPA Paper the Commission indicated the possibility of using some form of scenario analysis to reflect future possible events faced by the EDB, without defining how that would work in practice (paragraphs 278 – 280), and the 2010 SPA Paper proposes neither a scenario approach nor any other forecast method.

the capability of providing any statistical assessment of the level of confidence in the forecasts. These issues are discussed in section 4.

22. The ENA recognises in principle it may be possible to have a forecasting component to the DPP starting price adjustment method in the future (once the relevant data are available and a coherent and statistically sound method has been developed and tested). For this reset the ENA considers the Commission should use this forecasting component as a check on the drift of forecast ROIs over the regulatory period, as described in section 5.
23. The third is the Commission makes judgements in relation to the development of its proposed starting price adjustment model in the belief that it is relatively straightforward and low cost for an EDB to secure a CPP. The ENA considers the Commission is mistaken in this belief.
24. We provide evidence in section 3 of the likely cost of a CPP from experience with similar regulatory processes in Australia, and identify a number of risks in the CPP process (from an EDB perspective) that are likely to deter an EDB from applying for one. Importantly, it is the EDB's perspective of CPPs which the Commission needs to take into account in this regard, as it is the EDB perspective which will underpin its decision as to whether or not to apply for a CPP. We discuss these issues in section 3 and recommend an approach in section 5 to address them by including a tolerance for error, thereby reducing the probability an EDB will need to apply for a CPP to correct for error.
25. Other comments on the Commission's proposed method are covered in the following sections and the Executive Summary includes all recommended improvements to the Commission's method.

3. Legal framework

Previous submissions

26. ENA has made previous submissions on the legal framework for the starting price adjustment methodology. In particular, we refer the Commission to our submission of 10 December 2010. The following is a summary of the key points from our previous submissions:
 - The starting price adjustment methodology must promote outcomes consistent with outcomes produced in workably competitive markets;
 - The Commission must ensure that (a) to (d) of the Part 4 Purpose are achieved;
 - The Commission must place more weight on incentives to innovate and invest than it did under Part 4A or the old Part 4. In the event that a tension

arises between (a) and other subparagraphs (in particular, with (d)), the Commission must give priority to (a);

- The methodology to adjust starting prices must be relatively low cost; and
- The starting price adjustment methodology should be an IM.

27. In this section we make further submissions on the Part 4 Purpose, the purpose of DPP/PPP regulation, the role of the PPP in designing the DPP, setting starting prices based on current and projected profitability, starting price adjustments in the context of section 54K(3), and the consultation process.

Purpose of Part 4

28. The starting price adjustment methodology has a direct causal relationship with the Part 4 Purpose. Starting prices are one of the key levers by which the Commission seeks to ensure that an EDB's returns represent normal profits that would generally be observed in a workably competitive market. Linking this back to the Part 4 Purpose, starting prices direct returns to a level such that suppliers have incentives to invest and innovate (a sufficient return) while limiting suppliers' ability to extract excessive profits (a limited return).

29. Observing this direct causal relationship, the fundamental importance of the starting price adjustment methodology and the need to get it right becomes obvious. All the long term value of setting IMs and establishing a credible, ex ante, low discretion price control regime will be lost if the starting price adjustment methodology is not robust.

30. Of course, being an ex ante revenue setting process, starting price adjustments cannot guarantee that suppliers earn a normal return over the regulatory period. In terms of promoting incentives to invest, the Commission must seek to determine a starting price adjustment methodology that gives suppliers a reasonable expectation of earning *at least a normal return*. The Commission has previously explicitly recognised this key principle in the context of designing the DPP:⁷

*If the regulated firm does not expect to make **at least a normal return** on its efficient incremental investments going forward, it would be unable to maintain the quality of its services and would have no incentive to invest further in order to meet the growth in consumer demand. **Such an outcome would not promote the long-term benefit of consumers...***

*As well as expecting to receive **at least a normal return** on its future efficient investments, a regulated firm should also be able to make a normal return on*

⁷ *Reset of Default Price-Quality Path for Electricity Distribution Businesses: Discussion Paper*, Commerce Commission, 19 June 2009, paragraphs 54, 56.

the efficient investments it has already made. This ensures that the firm will have incentives not just to remain in the market, but to make further efficient investments in replacement, upgraded and new infrastructure as well.
(emphasis added)

31. Ensuring suppliers have an expectation of earning at least a normal return requires that the starting price adjustment methodology is robust, accurate and inspires confidence in the industry. Investment capital is globally mobile and, if investors cannot be confident of earning at least a normal return, investment will shift to industries with better prospects. This is the real world reality that EDBs face and the Commission must recognise.
32. One further element of the Part 4 Purpose that is relevant to the Commission's exercise in determining a starting price adjustment methodology is the requirement to promote outcomes that are consistent with outcomes produced in competitive markets in the markets referred to in section 52 i.e. those markets with little or no competition and little or no likelihood of an increase in competition.
33. Each EDB operates in a discrete geographical market for the conveyance of electricity by line. The requirement under the Part 4 Purpose is to promote outcomes consistent with outcomes produced in workably competitive markets in each of those geographical markets. This has important implications for the industry forecasts that the Commission proposes to use. If those forecasts generate outcomes that are not consistent with those observed in workably competitive markets – say, by specifying a nationally averaged real revenue growth forecast that is materially different from the forecast in the discrete geographical market – the Commission's model will be inconsistent with the Part 4 Purpose.

Purpose of DPP/ CPP regulation

34. Section 53K provides:

The purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.

35. To be clear, the purpose statement applies to DPP/ CPP regulation as a regulatory package. The Commission is required to develop a regulatory package (comprised of the DPP and CPP) which is relatively low cost, and which allows the opportunity for individual suppliers to have alternative price-quality paths that better meet their particular circumstances. There are three key implications of the purpose statement which ENA wishes to make explicit:

- the CPP does not need to be low-cost. Rather, the requirement is for the regulatory package to be relatively low-cost (as we discuss later in this submission, the CPP is in fact a high-cost alternative);
 - the DPP must be low-cost. If the DPP is not low-cost then the regulatory package cannot be low-cost; and
 - although a low-cost DPP is a necessary condition, it is not sufficient. The DPP must be designed such that it is suitable for most suppliers and relatively few suppliers are forced to move to a CPP in order to have an expectation of at least a normal return. The alternative – where large numbers of suppliers are on the relatively high cost CPP – would mean that the regulatory package is not relatively low-cost and would therefore be inconsistent with the purpose statement.
36. In relation to the last of these three implications, the Commission appears to be in agreement:⁸
- In the Commission's view a DPP should be a generic tool, as far as practicable, such that under a DPP, price-quality regulation can be cost-effectively applied across multiple suppliers.*
37. Having acknowledged the importance of designing the DPP such that it can be cost-effectively applied across multiple suppliers, the Commission's proposed starting price adjustment methodology runs contrary to that view. This is because the proposed methodology does not provide for a margin of error in the case of an overestimation of a supplier's profitability. Where the profitability of a supplier is overestimated (which would likely be a frequent occurrence under the Commission's approach given the generic nature of the DPP and the reliance on industry-wide forecasts) it will be required to apply for a CPP to give an expectation of a normal return.
38. The risk inherent in the Commission's starting price adjustment methodology is that a large number of firms will need to apply for a CPP. This will raise the cost of the regulatory package such that it is not a relatively low-cost way to set price-quality paths. The Commission's proposed methodology is therefore likely to be inconsistent with the purpose of DPP/ CPP regulation.
39. The method for starting price adjustments that we propose in section 5 below solves this problem by adjusting starting prices such that the projected ROI for each EDB equals the 75th percentile of the WACC range plus a margin for error. This should ensure that the DPP provides an expectation of at least a normal return for most EDBs, while limiting the ability of EDBs to extract excessive profits.

⁸ *Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*, Commerce Commission, 5 August 2010, paragraph 2.8.

Role of CPP in designing the DPP

40. In the 2011 SPA Paper, the Commission gives consideration to the role of the CPP in designing the DPP and starting price adjustment methodology. In this section ENA responds to the Commission's view of the role of the CPP.
41. The purpose of DPP/ CPP regulation gives guidance on the proper role of the CPP. In addition to the low-cost purpose, the purpose of DPP/ CPP regulation is to allow:

... the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.

42. Clearly, the CPP is the mechanism that gives the opportunity for suppliers to have alternative price-quality paths that better meet their particular circumstances – that is, the CPP is the “alternative” to the DPP.
43. In essence, the role of the CPP is to provide a supplier with an expectation of at least a normal return where the DPP would not provide such an expectation, because the DPP does not sufficiently meet the particular circumstances of the supplier. The clear policy intent was that CPPs serve as an alternative price-quality path for suppliers with investment requirements which deviate significantly from the average. This policy intent is evident in:
- the repeated emphasis of the Ministry of Economic Development (MED) on extraordinary capital expenditure as the key reason for applying for an alternative price-quality path. See paragraph 171 of MED's *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document* where it is implicit that CPPs are expected to relate to “significant capital expenditure (that is, of a different level and character than in the recent, say 10 years, past) required in order to meet customers' quality expectations and requirements”;⁹ and
 - the comments of then Minister of Commerce Lianne Dalziel at the First Reading on the Commerce Amendment Bill.¹⁰

Suppliers may apply to the commission for a customised price-quality path if they have special requirements, such as needing to make significant new investments...

The replacement of Part 4A is expected to provide much more certainty for businesses, including giving them an upfront opportunity to get

⁹ *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, Ministry of Economic Development, April 2007, paragraph 171.

¹⁰ Parliamentary Debates (Hansard) for Thursday, 10 March 2008.

approvals for customised price-quality paths to cover the cost of a step change in investment requirements, for example.

44. In ENA's view, the Commission has made the mistake of treating the CPP as a safety valve (in fact, the only safety valve) for uncertainty or inaccuracy in the DPP. See in particular the views of the Commission in the following paragraphs of the Update Paper:

- paragraph 2.27 – *“The Commission considers that the proposed approach does not need to provide further bias in favour of suppliers, by providing for uncertainty in profitability forecasts. In the situation that the DPP was not appropriate for a supplier, it may apply for a CPP.”*
- paragraph 4.59 – *“The Commission considers that the existence of a regulatory package which allows for an alternative to the DPP (i.e. CPP) should be taken into account when valuing the potential impact of adjusting the starting price where there is some uncertainty.”*
- paragraph 4.62 – *“Suppliers' option to apply for a CPP limits the adverse effect of any potential overestimation of the profitability of suppliers relative to the WACC (including the effects of using industry-wide parameters).”*

45. In short, a supplier that is put in the position of having to apply for a CPP to respond to errors in the Commission's forecasts is not doing so because of that supplier's particular circumstances. These are two distinct regulatory issues.

46. The Commission's approach reflects something of a turnaround from its view of the role of the CPP in its August 2010 Starting Price Adjustments Discussion Paper. In the Discussion Paper, the Commission focussed on the role of the CPP as an alternative price-quality path for suppliers which had different expenditure requirements from the average, rather than as a safety valve for uncertainty or inaccuracy in the starting price adjustment methodology. At paragraph 3.18 of the Discussion Paper, the Commission states:

The Commission recognises that there may be circumstances where future expenditure requirements differ significantly from those implied by the starting price. Therefore the starting price adjustment process might not appropriately reflect those particular circumstances of a supplier that affected its projected profitability. In such instances, there are likely to be alternatives available to the supplier for better meeting these particular circumstances as contemplated by s 53K, such as the option of making a CPP proposal.

47. This shift of view occurred as the Commission moved away from the ROI band concept which did provide a safety valve for uncertainty or inaccuracy in the starting price adjustments. However, the Commission has not given reasons for dropping the ROI band concept from its proposed methodology.

48. ENA is concerned that using the CPP as a safety valve derogates from the duty of the Commission to develop a robust DPP which can be “cost-effectively applied across multiple suppliers”. The Commission’s approach represents a fundamental misunderstanding of the role of the CPP in the DPP/ CPP regulatory package, and one which is likely to increase the cost of regulation for the industry and consumers. This is contrary to both the Part 4 Purpose and the purpose of DPP/ CPP regulation.
49. The Commission has also erred in its view that undertaking a CPP would involve minimal cost and is relatively simple. A central plank of the Commission’s logic in proposing a starting price adjustment methodology with no margin for error is that moving to a CPP should present no significant difficulties or cost for an EDB, and therefore the CPP effectively operates as a margin for error. ENA submits that this view is incorrect.
50. In fact, the cost of undertaking a CPP application and moving to the CPP is likely to be substantial for a supplier. The Commission claims that the only real marginal costs would be those of the audit and the independent verification of the CPP proposal, and further suggests that “most (if not all) of the information necessary to prepare a CPP proposal should be readily available to a supplier, whether or not it is applying for a CPP”.¹¹
51. The Commission is clearly making an assumption about the level of information that a prudent and commercial supplier will generate as part of business-as-usual processes. However, the EDBs which support this submission are adamant that this is simply not the case. The Commission frequently cites the information asymmetries between it and suppliers, yet in this case it is confident that suppliers do in fact have all the relevant information readily available. This is surprising, and has resulted in the Commission relying heavily on a mistaken assumption.
52. Additionally, where relevant information is held it will in many cases require significant amendment to be made suitable for disclosure under a CPP application. Significant resource will need to be applied to review the information for consistency with the Commission’s requirements. The Commission cannot assume that the information exists and is ready to deliver to the Commission in reviewable form.
53. ENA refers the Commission to two estimates of the cost of making a CPP proposal:

¹¹ *2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments: Update Paper*, Commerce Commission, April 2011, paragraph 4.64.

- Powerco estimated that its costs of making a CPP proposal would be between \$1.5 and \$2 million. This includes using three internal staff and external consultants for up to a period of 18 months.¹²
 - The Australian Energy Market Commission asked suppliers what costs would be incurred in preparing and participating in an assessment of a revenue/regulatory proposal. Suppliers generally indicated a cost of \$2 million to \$5 million for an individual regulatory assessment.¹³
54. While these costs are only indicative, they are far from insignificant additional costs and do strongly suggest that a CPP application would be expensive in terms of direct costs.
55. There are also significant risks to an EDB in moving to a CPP. Section 53V provides that the Commission may determine any customised price-quality path that the Commission considers appropriate for a supplier that has made the proposal, and may apply claw-back. There is a real degree of uncertainty in the discretion of the Commission to determine a price-quality path that is “appropriate”. The risk and unpredictability of outcome is likely to be greater at the start of the regulatory regime as the approval process is fresh and untested. The risk of uncertain outcome is likely to deter EDBs from moving to a CPP and this is factor that the Commission must take into account.
56. In summary, the Commission’s proposed starting price adjustment methodology is predicated on the assumption that the CPP will compensate for the lack of a margin of error in the DPP. This is not the role of the CPP, and the Commission is mistaken in its belief that a CPP is relatively inexpensive and simple. This is a real concern for ENA, as we consider it highly likely that the Commission’s method for assessing starting prices will produce errors, including the overestimation of profitability.
57. Although the CPP is not the appropriate mechanism to provide for a margin for error, ENA does consider that a margin for error is required to account for inaccuracies and uncertainties in the DPP, and to give investors confidence that suppliers will earn at least a normal return. Our proposed method in section 5 of this submission includes elements that are intended to provide a margin for error.

¹² *Post Workshop Submission Customised Price-Quality Path*, Powerco Ltd, 19 April 2010, paragraph 24.

¹³ *Perspectives on the Building Block Approach: Review into the use of total factor productivity for the determination of prices and revenues*, Australian Energy Market Commission, 30 July 2009, paragraph 3.4.

Starting prices based on current and projected profitability

58. Section 53P(3)(b) provides that the Commission may set starting prices “based on the current and projected profitability of each supplier”. This is the first reset of the DPP where the Commission proposes to set starting prices based on the current and projected profitability of each supplier.
59. While there is some ambiguity in what is meant by the test of “current and projected profitability of each supplier”, it is obviously correlated with the objective inherent in starting price adjustments to keep supplier returns at an appropriate level over the regulatory period. Where current and projected profitability:
- is excessive, a downward adjustment in prices will be required; and
 - is insufficient, an upward adjustment will be required.
60. The Part 4 Purpose requires the Commission to adopt the best method for assessing current and projected profitability based on the available data. The regulatory objectives in the Part 4 Purpose will be undermined if the Commission’s assessment of current and projected profitability is inaccurate.
61. In ENA’s view, the Commission’s method and data for measuring projected profitability is deficient. We note that the section requires the measurement of current and projected profitability of “*each supplier*”. The Commission’s proposed approach operates on an untested assumption that industry-wide forecasts are the best possible proxy for assessing the projected profitability of each supplier (keeping in mind the need for the DPP to be low-cost).
62. However, ENA submits that there are fundamental flaws in the use of certain industry-wide forecasts to assess the projected profitability of each supplier. We intend to comment more on these flaws in the submissions on industry forecasts due 23 May 2011, but our headline concern is that the forecasts cannot be reasonably expected to operate as a proxy for the projected profitability of each supplier.
63. The Commission’s method to estimate commencing ROIs using one year’s data, plus its method to forecast that value over the regulatory period produces a result which would reflect the underlying ROI of an EDB only by chance. ENA does not consider that it is reasonable to rely on the results generated from the Commission’s model as a measure of current and projected profitability.
64. For these reasons there is a real issue as to whether the Commission is in fact applying the statutory test of basing starting prices on the current and projected profitability of each supplier.
65. As we discuss in section 5 of this submission, the better method and data for assessing the current and projected profitability of each EDB is to use the 2009/10 ROIs (adjusted for consistency with the input methodologies). The

absence at this point in time of a data series and a robust method to undertake forecasts of these reported ROI values means any attempt at doing so can be expected to add rather than reduce error in this estimate.

Consultation process

66. Finally, ENA wishes to register its concern over the recent process to develop the starting price adjustment methodology. While we appreciate the work of the Commission in reviewing and developing the methodology, the Commission's proposal is considerably different from what it previously proposed. This change was not signalled to the industry and the relatively short timeframe in which to respond to the new methodology has put the industry under real pressure.
67. Additionally, the Commission has not properly explained why it has moved away from the ROI band concept that it previously proposed. Combined with the short timeframe to respond to a very different methodology, the industry has been put at a disadvantage in the consultation process.

4. Estimating and forecasting ROI

Estimating ROI at the commencement of the regulatory period

68. The Commission proposes estimating the ROI of each EDB at the commencement of the regulatory period (i.e. for the year 2010/11) by simply taking the ROI values reported for 2009/10 (adjusted for the IMs), and rolling that value forward using three industry-wide and one economy-wide forecasting assumptions.
69. This approach places 100% weight for the commencing ROI estimate on a single year, despite the Commission itself identifying in its two previous papers the weaknesses of doing so (see footnote 3), and its adviser Economic Insights advising against this approach (see footnote 4). Thus the Commission, in proposing to base its estimate for commencing ROIs on one year's data, is taking a position contrary to its previous stated views and those of its adviser. The Commission is not explicit as to why it chooses to take this approach,¹⁴ but we infer it does so due to the absence of a longer time series of ROI data reported consistent with the IMs.
70. The ENA accepts that for this reset data for estimating the level of the commencing ROI, prepared on the basis of the IMs, will be available for one

¹⁴ See paragraphs 4.1 to 4.3 of the 2011 SPA Paper.

year only (2009/10). In future resets a longer data series will be available so we would expect a method will be used in those resets that is capable of using such a series. The statistical implications of using one year's data only is that this estimate will be subject to a higher level of uncertainty as to whether it reflects the underlying ROI of an EDB than would be the case if a longer series were used. The Commission however ignores this statistical implication of using one year's data for this estimate and treats this estimate as if it can have 100% confidence that it reflects an EDB's underlying ROI. It does not provide a statistical basis for taking this approach.

71. The Thomson/van Zijl report provides statistical estimates for the dispersion of EDB ROIs over time. The Commission, however, makes no use of the material in this report to assess the statistical confidence of its estimated commencing ROI.

Forecasting ROI throughout the regulatory period

72. It appears the Commission considers that the forecasts it develops of an EDB's ROI over the regulatory period will in some way address the issue of placing reliance on one year's data only. This is not the case, as the forecast method drives off the estimated commencing ROIs and its components (and therefore carries any error forward in those forecasts), plus the forecast assumptions do not reflect the individual circumstances of each EDB, and therefore this forecasting method would address any initial estimation errors by chance only. It is notable that the proposed forecasting method provides no statistical measure of the confidence of the forecasts.
73. The ENA considers the Commission needs to be cautious in the extent to which it places weight on its proposed forecasts. These forecasts neither reflect historical trends of each EDB's business nor an EDB's projection of its business in its AMP. The real revenue growth assumption, to which the Commission's model is very sensitive, aims to reflect average real revenue growth across the sector. However, growth has and is expected to vary very significantly across EDBs. Further, the metrics in this real revenue growth estimate and their weightings do not correspond to those used by EDBs in their pricing structures and therefore the forecast growth in these metrics is not a credible proxy for growth in an EDB's revenue. The ENA will be providing a further submission on these issues consistent with the Commission timetable for submissions on these assumptions.
74. In relation to the forecast CPI assumption, it needs to be aligned to the implicit inflation expectations in the WACC estimate, but this is not the case in the proposal as these values were derived at a different point in time to when the WACC parameters were estimated.
75. In addition to problems with the forecast assumptions, the forecast method is ad hoc in the sense that one method is used to estimate the commencing ROI

(taking one year's data point), while another set of methods (i.e. estimates of industry and economy-wide assumptions) are used to generate forecast assumptions. These methods do not have a statistical basis and are not capable of providing a statistical assessment of confidence in the forecasts. This approach therefore fails to provide the Commission with any measure of the level of confidence it can place on these forecasts. This is despite the Commission in its 2010 SPA Paper stating its intention to use statistical assessments to inform the setting of ROI band limits, in recognition of the variability in the ROI data (paragraphs 4.19 – 4.21).

76. Given the lack of time series data to provide the basis for credible forecasts at the EDB level, and the absence at this stage of a statistically robust method acceptable to the Commission, the ENA considers the Commission should place less weight on this aspect of its proposed model. The ENA recognises in principle it may be possible to have a forecasting component to the DPP starting price adjustment method in the future, once the relevant data series are available and a coherent and statistically sound method has been developed and tested. The ENA describes in section 5 the way in which the Commission's proposed forecasting component could be used as a check on the drift in ROIs over the regulatory period.

Addressing uncertainty

77. The Commission's method to estimate commencing ROIs using one year's data, plus its method to forecast that value over the regulatory period produce a result which would reflect the underlying ROI of an EDB only by chance. The Commission, however, is proposing to adopt this result as a certain estimate of an EDB's underlying ROI when adjusting DPP starting prices, and to rely on an EDB to apply for a CPP to correct any error in the resulting starting prices.
78. The Commission's logic in taking this approach is based on the premise that a CPP is low cost and low risk to an EDB, and therefore is a ready error correction mechanism. We provide evidence in section 3 that this is not the case, and that CPPs were not designed for this error correction role.
79. In a context where a CPP imposes significant costs and risks, the Commission needs to consider other means of addressing error in its starting price adjustment method. In its two previous SPA Papers the Commission included margins for error (by way of bands). For reasons that are not explicit it has moved away from building in a tolerance for error in its 2011 SPA Paper.
80. The ENA commissioned the Thomson/van Zijl report to explore and identify ways to handle uncertainty in a transparent and statistically sound manner. In the next section we recommend modifications to the Commission's proposed method that make allowances for the uncertainty the Commission confronts in its task of adjusting starting prices.

81. Lastly, we note the Economic Insights review conflates two sources of uncertainty in its response to the Thomson/van Zijl report, that is uncertainty in the estimate of WACC and the estimate of an EDB's underlying ROI.¹⁵ The Commission has chosen to adopt its so-called 75th percentile estimate of WACC to take account of uncertainty in its WACC estimation methods. The use of a control limit in the Thomson/van Zijl report is to take account of the dispersion of reported EDB ROIs. Both sources of uncertainty need to be taken account of and it is incorrect to conflate them (and thereby dismiss the latter as not needed) as in the Economic Insights report. The Commission recognises this in its 2010 SPA Paper where it states (paragraph 4.16):

The Commission notes that uncertainty in the returns assessment is distinct from the uncertainty in determining an appropriate WACC point estimate.

5. Proposed modifications to method

Issues that constrain and inform the Commission's method

82. The discussion in sections 3 and 4 above identifies that the context within which the Commission is undertaking any adjustment to DPP starting prices includes the following:
- It has available to it only one year of disclosures that have been prepared consistent with the IMs (2009/10).
 - It has evidence on the way in which EDBs' ROIs move over time, from the Thomson/van Zijl report, including estimates of confidence intervals for this data series.
 - It has derived an estimate of WACC for EDBs.
 - It has very limited data on which to base a forecast of an EDB's profitability for 2010/11 onward, and no statistically robust method for undertaking such forecasts.
 - It has evidence from EDBs that the cost to them of undertaking a CPP is high, plus the EDB perception that the risks of doing so are high, meaning CPPs are not a readily available and low cost mechanism to correct DPP price adjustment errors.
 - The Commission operates pursuant to a purpose statement that requires the promotion of outcomes such that:

¹⁵ See page iii of the Economic Insights report.

- EDBs have incentives to innovate and to invest, which requires an EDB to have a reasonable expectation that it is able to earn at least its WACC.
- EDBs are limited in their ability to extract excessive profits, which suggests an EDB's expected return needs to be limited at some level above WACC.

Proposed method

83. This context constrains very significantly the credible and lawful options available to the Commission to undertake any adjustment of DPP starting prices. The ENA recommends the following method for adjusting DPP starting prices, given this context:

- That 2009/10 ROIs, prepared on the basis of the IMs, be used as the estimate for current and projected profitability for each EDB.
- That the 2009/10 disclosed values be rolled forward to project a 2010/11 ROI, and that starting prices as at 1 April 2010 be adjusted such that the projected ROI for each EDB equals the Commission's estimate of WACC plus at least one standard deviation of the ROI series as assessed in the Thomson/van Zijl report.
- That this adjustment in starting prices as at 1 April 2010 be rolled forward to 1 April 2012 using the DPP Determination calculations, in order to reflect this adjustment in Allowable Notional Revenue for each EDB for the year commencing April 2012.

84. The logic for this approach is as follows:

- The 2009/10 ROIs are the best estimates the Commission has of the current and projected profitability of each EDB. The absence at this point in time of a data series and a robust method to undertake forecasts of these reported ROI values means any attempt at doing so can be expected to add rather than reduce error in this estimate (and by implication require an even wider margin for error than that identified in the Thomson/van Zijl report).
- Consistency with the purpose statement requires the Commission to use a method for adjusting DPP starting prices that promotes outcomes in which each EDB can expect to earn at least its WACC, given the evidence available to the Commission, while retaining a low-cost approach.
- In order for the Commission to have confidence (in a statistical sense) that any starting price adjustment is consistent with the purpose statement it needs to take account of the potential for Type One errors (or false positives), that is where starting prices are set at a level that does not enable an EDB to expect to earn at least a WACC return.

- The Thomson/van Zijl report provides the best estimate available of the dispersion of EDB ROIs over time. The calculation of ROIs using the IMs may change their absolute level but are unlikely to change their variability significantly, and therefore these estimates remain relevant.
 - This estimate of the dispersion of EDB ROIs enables the Commission to calibrate its method to ensure it has a specified level of confidence in the results in terms of false positives. Adding one standard deviation of the ROI dispersion to WACC would result in the probability of 15.87% for false positives, and adding two standard deviations would result in a probability of 2.28%.
 - The ENA has previously recommended this false positive rate be set at 2.28% (that two standard deviations be used). The Commission disagreed with this view, but when doing so incorrectly conflated this issue with uncertainty related to the estimation of WACC. The ENA remains of the view that the Commission is obliged to take account of the evidence before it on the dispersion of EDBs' ROIs and the implications of that dispersion for uncertainty in its decision making. The ENA considers at a minimum at least one standard deviation needs to be allowed for in these circumstances (for reasons of asymmetrical economic effects of error, the costs and risks associated with a CPP, and the requirements of the purpose statement).
85. The modified Commission spreadsheet model, attached to this submission, incorporates these recommended changes which are labelled as "Step One" in that model.

Possible use of forecasting ROIs

86. The Commission's proposed method also includes a forecasting component. The ENA considers this component, given the very limited data available at this time and the use of industry wide (rather than EDB specific) assumptions, would be best used as a check on the drift in ROIs over the regulatory period. This check could be undertaken as follows:
- Once initial price adjustments have been calculated as described above, the ROIs for each EDB are forecast for the regulatory period.
 - For those EDBs whose forecast ROIs do not drift outside of a band with WACC as the lower bound, and plus two standard deviations of ROI dispersion to provide the upper bound, no further price adjustments are made. The use of two standard deviations in this case reflects the greater level of uncertainty introduced by the forecasting method and the assumptions used in those forecasts.
 - For those EDBs whose forecast ROIs drift above or below the boundaries of the band over the five year period (or three year period if that is used), their starting prices are adjusted by an amount to reflect the PV of earnings that

is represented in the forecast ROIs exceeding, or moving below the boundaries of the band.

87. This forecasting extension is described as “Step Two” in the spreadsheet model attached to this submission.

6. Other proposed amendments to the DPP

88. The 2011 SPA Paper also proposes a number of other amendments to be made to the DPP pursuant to the following provisions in the Act:

- s 54K(3) by amending the DPP under s 53P(1) using s 52Q; and
- other amendments to be made under s 52Q.

89. The provisions in s 54K(3) specifically relate to the 2010-2015 DPP. If IMs are published after 1 April 2010, and if they would have resulted in a materially different price or quality paths being set, then the 2010-2015 DPP may be reset. This may only occur within 9 months of the date of publication of the IM.

90. Other amendments to the DPP may only be made:

- consequential on appeal of an IM (under s 53ZB subject to a materiality test);
- within a DPP period only if a ‘re-opener’ circumstance is triggered (as defined in the DPP processes and rules IM as provided for in s 52T(1)(c)(ii)); and
- under s 52Q which provides the procedural requirements for material and non material amendments to a 52P determination.

91. The ENA’s submission of 27 September 2010¹⁶ set out an analysis of these legislative provisions and concluded:

The ENA submits that a reasonable interpretation of the Part 4 provisions for setting the DPP is that:

- *the DPP must be set for a defined period;*
- *it may only be reopened in limited circumstances to be determined in advance in accordance with the pending processes and rules IM; or after the DPP has been set in the case of errors or omissions; and*

¹⁶ *Submission on Default Price-Quality Path Refinements*, Electricity Networks Association, 27 September 2010

- *transitional provisions apply for a nine month period following the 2010 IM determinations where changes may be implemented where they would result in a materially different DPP had the IMs applied when the DPP was initially determined.*¹⁷

92. Our comments below on the proposed changes to the DPP are consistent with this interpretation.

Changes to be made under s 53(K)(3)

93. The 2011 SPA Paper proposes that the following amendments will be made to the 2010-2015 DPP under the s 54K(3) provision for material changes to the price path resulting from the IM. The Paper does not indicate how the Commission has formed its views on the ‘materiality’ of these proposed changes, as would be expected given the s 54K(3) wording.

94. The proposed changes include amended definitions for:

- price, posted discount and GST;
- electricity distribution service; and
- pass through and recoverable costs.

95. The definitions would be changed to refer directly to the DPP Processes and Rules IM determination which in turn refers to the Part 1 General Provisions, 1.1.4 Interpretation definitions. Other terms will be deleted as a result, including:

- avoided transmission charges and transmission charges; and
- Electricity Commission Levy and Commerce Act Levy.

96. In addition, the compliance assessment formula is to be amended to incorporate the new recoverable cost term.

97. These changes appear reasonable as they reflect amended definitions for terms which are included in the existing DPP, but which have now been altered in the IMs. We note it is not clear to what extent the proposed changes meet the ‘materially’ different price path test within s 54K(3) and the 2011 SPA Paper provides no evidence to support this test. We note that all of these proposed amendments have a direct impact on the price path formula itself or the inputs relevant to that formula.

98. An additional proposed change is that the definition of CPI is to be amended to be consistent with the definition of CPI included in the IMs (specifically 3.1.1(2))

¹⁷ Ibid, paragraph 4

and 1.1.4(2)). The ENA has submitted previously on reasons why this change in the definition of the CPI should not be made for the purpose of the DPP,¹⁸ and remains of this view.

Process for Approval of Recoverable Costs

99. The 2011 SPA Paper addresses a new component of the DPP introduced through the IM consultation process. This refers to the avoided transmission component of recoverable costs which is able to be recovered by an EDB following the purchase of transmission assets from Transpower. The intention is to provide incentives to suppliers subject to the DPP to undertake such activity by allowing them to retain the benefits of avoided Transpower charges for a period of five years before they are passed on to consumers (by way of lower recoverable costs). Section 3.1.3(1) of the IMs sets out the provisions for the relevant recoverable cost as follows:

3.1.3(1) (e) an amount of a charge described in paragraphs (b) or (c) that the Commission is satisfied an EDB has avoided liability to pay as a result of the EDB having purchased transmission assets from Transpower, subject to-

- (i) the requirement specified in subclause (2); and*
- (ii) subclause (4);*

and

3.1.3 (2) The requirement of this subclause is that in respect of a particular EDB, the Commission's approval for the amount of cost must be obtained in accordance with any process relating to the type of cost in question specified in a DPP determination.

and

3.1.3 (4) For the purpose of subclause (1)(e)(ii), the amount is a recoverable cost only in the 5 disclosure years from and including the disclosure year in respect of which the Commission first approved the amount of the cost.

100. In this respect the definitions of avoided charges in 3.1.3(1)(e) refer to:

(b) a charge payable to Transpower for electricity lines services provided to a non-exempt EDB in respect of the transmission system in accordance with the transmission pricing methodology Transpower uses to determine the prices it charges for its services, as specified in the Electricity Industry Participation Code;

¹⁸ Ibid, paragraph 66.

(c) a charge payable to Transpower in respect of a new investment contract (as 'new investment contract is defined in the Electricity Industry Participation Code) between those parties, or an equivalent type of contract, subject to the requirement specified in subclause (2);

101. In order to implement this new component of DPP recoverable costs, the 2011 SPA Paper proposes that (paragraphs 8.8 – 8.11):
- In respect of 3.1.3(2) regarding the Commission’s approval process, the approval will be undertaken during the Commission’s review of annual DPP Compliance Statements. Thus a supplier will include in its audited Compliance Statement the relevant amount for the recoverable cost for the current assessment period on an ex post basis. The ENA supports this proposed process which is cost effective, will be based on historical not forecast data, and is subject to independent audit. In addition to the independent audit, Director’s certification is required for the Compliance Statement.
 - The recovery period will commence at the date of the asset transfer, continue to the end of the current assessment period (i.e. disclosure year) and the four subsequent assessment periods. This is consistent with 3.1.3(4) and is supported.
 - The amount able to be recovered is to be no more than the nominal amount recovered in the year of the asset transfer which is to be annualised for the subsequent four years if the transfer occurred partway through the first year. This is inconsistent with the definition of recoverable cost contained in 3.1.3(1)(e) and therefore the ENA does not support it, as discussed below.
102. The IM provides for the avoided Transpower charges to be included as recoverable costs for a period of 5 years (including the year of asset transfer) where *“the Commission is satisfied an EDB has avoided liability to pay as a result of the EDB having purchased transmission assets from Transpower”*(s 3.1.3(1) (e)). These costs are defined with reference to the Transmission Pricing Methodology (TPM) and other components of Transpower charges defined in the Electricity Industry Participation Code.
103. The Commission’s proposal departs from this definition as it limits the annual recovery to the value of the avoided Transpower charges in year one of the recovery period. This is inconsistent with the value of the charges which will be avoided over the five year period as defined in 3.1.3(1)(e) as it is unlikely that Transpower’s charges will stay constant in nominal terms over the five year recovery period. Historical experience supports this view. At the time EDBs consider asset purchases, they will as a matter of normal commercial practice estimate the expected value of the Transpower charges they will avoid. This will likely involve information provided by Transpower for this purpose.

104. At the time an EDB sets its prices each year (i.e. prior to each assessment period) it will be possible for it to confirm and if necessary amend these assumptions, as the TPM and its various component values are available for the forthcoming pricing year in advance. The EDB's Compliance Statement, which is prepared ex post, would confirm these assumptions and calculations against the TPM and the asset and load data relevant to the EDB.
105. The Commission states (paragraph 8.10):
- The avoided cost could potentially be reassessed each year to allow for changes in demand, but this would likely be more subjective.*
106. We agree that the avoided cost could (and should) be able to be updated each year for changes in demand (and other changes such as in price), but we disagree that such an approach would be more subjective. As explained above, such changes will be able to be undertaken using verifiable information that is subject to independent audit.
107. Thus the ENA supports the Commission's proposed process for approving these recoverable costs (by way of disclosure in the Compliance Statement), but disagrees that the IM definition of the "avoided costs" should be modified or redefined as referring to the nominal costs avoided in the first year only.
108. Lastly, we note EDBs will have set prices for the relevant assessment period based on their assessment of avoided Transpower charges. In anticipation that the Commission could conceivably form a different view following review of the EDB's Compliance Statement after year end, and "approve" a different amount, there would need to be a process developed to accommodate an adjustment to recoverable costs in future assessment periods. The 2011 SPA Paper does not indicate how the Commission would address this issue.

Changes to be made under s 52Q

109. Other changes are proposed to be made under s 52Q, the difference being they do not directly relate to the price path already contained in the 2010 DPP. The 2011 SPA Paper suggests some of these are material and some are immaterial, although it is not specified which of the proposed changes fall into each category.
110. The Commission is required to consult on any material changes to a determination made under s 52Q. The 2011 SPA Paper requests comments on all of the proposed amendments.
111. The proposed amendments include:
- references to and consistency with process relevant to the DPP which are set out in the IMs, in particular relating to CPP application windows, reopeners and broad acknowledgement of the relevant IMs;

- stylistic changes; and
 - a revised definition of Director.
112. These proposed changes appear reasonable and are supported.
113. One issue that does not appear to be addressed in the 2011 SPA Paper is the possible timing for CPP applications, and the time from which any CPP would take effect, should they be necessary following any adjustment to DPP starting prices as at April 2012.

Amalgamations

114. The 2011 SPA Paper includes more detailed commentary on proposed changes to the provisions relating to amalgamations (as defined in the Companies Act) and as set out in s 3.2.1 of the IMs. Currently the DPP includes provisions for adjusting DPPs in the event of a merger or acquisition (which in turn refers to purchases, mergers, takeovers, disposals or other similar transactions).
115. The 2011 SPA Paper does not explain whether the Commission believes the IM definition of amalgamation differs in intent to the DPP definitions of mergers and acquisitions. We believe they are consistent.
116. In any event the ENA supports the following in principle (which we believe is consistent with the intent of s 3.2.1 of the IMs and the current DPP) that:
- where two or more non exempt EDBs are involved in a transaction (inclusive of amalgamations) which involves change in ownership of their regulated businesses and where they are all subject to a DPP, the DPPs which relate to the regulated services in question should be combined in the assessment period immediately following the assessment period in which the transaction occurred; and
 - where the above is true except that at least one EDB is subject to a CPP, the CPP is not combined with the DPP(s) of the relevant EDBs until the end of the CPP, at which time a DPP will be applied to the combined regulated services.