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# ***Submission to the Commerce Commission***

on

2010 – 15 Default Price-Quality Path  
Starting Price Adjustments and Other  
Amendments

16 May 2011

Made on behalf of 19 Electricity  
Distribution Businesses



# ***Submission on 2010 -15 Default Price Quality Path Starting Price Adjustments and Other Amendments Update Paper***

This paper forms our submission on the Commerce Commission's (Commission's) 2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments Update Paper (the Update Paper), which has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 19 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
- Waipa Networks Limited
- Westpower Limited.

These businesses together supply 23% of electricity consumers, maintain 41% of total distribution network length and service 73% of the total network supply area in New Zealand. They include both consumer owned and non consumer owned businesses; and urban and rural networks located in both the North and South Islands.

The submission is structured as follows:

- Regulatory framework for non-exempt EDBs
- Alternative model
- Measuring current profitability
- Measuring projected profitability
- Proposed Starting Price Adjustment (SPA) process
- Other proposed changes to the Default Price-Quality Path (DPP)

## ***Regulatory Framework***

1. The proposed SPA method as set out in the Update Paper attempts to ensure that suppliers may be expected, *ex ante*, to earn at least a normal return over the regulatory period. It does this by projecting revenues and costs from a 2010 base year for each non-exempt EDB using industry wide forecasting assumptions for revenue, opex and capex. It may be possible for a supplier to earn, *ex post*, greater than

normal returns as a reward for superior performance. This assumes the supplier is able to implement productivity improvements which exceed the assumed industry wide productivity performance. In practice under the Commission's proposed model, these will also be available for those suppliers which are able to exceed the revenue forecast assumed by the Commission, and/or incur lower costs than those forecast by the Commission. Conversely suppliers can be expected *ex post* to earn lower than normal returns if they are unable to match the productivity improvements assumed in the industry wide X factor assumption, and/or incur higher costs or earn lower revenues than those embodied in the Commission's forecasts.

2. The proposed approach views the DPP and the Customised Price-Quality Path (CPP) option as two components of the same regulatory framework. That is the CPP exists as an alternative to the DPP, not as a standalone regulatory mechanism. Thus the Commission has explicitly recognised in its proposed design of the DPP, and specifically the manner in which starting prices are set for each DPP period, the option for suppliers to apply for a CPP.
3. Although the CPP is an alternative available to the DPP, the CPP should not in our view be used as a back-up option to address methodological flaws in the DPP. The purpose of the combined DPP/CPP regulatory framework is intended to be relatively low cost as set out in the section 53K purpose statement for default/customised price-quality regulation. We believe that a reasonable interpretation of this purpose is that the DPP is intended to apply to most EDBs, most of the time. Indeed the Commerce Act includes specific provisions which may deter suppliers from applying for a CPP including:
  - No CPP application may be withdrawn
  - A CPP application must be publicly available
  - The Commission may defer consideration of a CPP under certain circumstances
  - A CPP may result in terms which are less beneficial to a supplier than a DPP.
4. In addition, a CPP requires a supplier to justify all aspects of its forecast revenues and costs to the Commission for the proposed CPP period. Justification of target quality standards may also be required. This is not required under the DPP. This is a disincentive to applying for a CPP and introduces investment risk which does not exist under a DPP.
5. The Update Paper proposes that the cost of applying for a CPP is the cost of an application. This is assumed to be made up primarily of auditing and verification costs. We disagree with this assertion. The costs of making a CPP application are likely to be considerably more than audit and verification. They will include the costs of preparation of the large volume of qualitative and quantitative information which must be submitted with the CPP application. This point was made by a number of submitters during the CPP Input Methodology (IM) consultation process including the EDBs which support this submission. It was a notable point of difference between suppliers and the Commission and its advisors during this consultation. Paragraph 4.64 of the Update Paper illustrates this point of difference, as the Commission refers to the expectation that most (if not all) of the information necessary to prepare a CPP proposal should be readily available to a supplier.
6. We acknowledge this was the view of the Commission and its advisors during the CPP consultation process – it was not however the view of the EDBs which support this submission as set out in our previous submissions on this topic.<sup>1</sup> We retain the view that, having considered the final CPP information requirements as set out in the IM, EDBs will need to invest considerable resource in preparing the information required to support a CPP proposal in a form which is suitable for external review and verification. In addition this information will be required to support at least five years of expenditure forecasts which will become locked into a price path. This discipline is not required in normal business circumstances, as businesses are able to continually refine their forecasts and procedures over time. The Commission should not underestimate this cost to suppliers.
7. The Commission has provided examples of the types of circumstances it expects will trigger a CPP application. One example which the Commission has used frequently is to provide for a step change in investment.<sup>2</sup> Indeed the IM Reasons Paper states that the step changes in future expenditures relative to

<sup>1</sup> Refer for example PwC, Submission on the Draft CPP Input Methodology, 23 August 2010, paragraphs 23-24

<sup>2</sup> Refer Commerce Commission, Update Paper, 11 April 2011, paragraph X.20

historical expenditures are likely to be a key reason for a CPP application.<sup>3</sup> Another is in response to a catastrophic event or a change in quality standards.<sup>4</sup> We agree that it is reasonable for a supplier to apply for a CPP in circumstances which are a step change from historical or “steady state” positions. Paragraph 4.68 of the Update Paper refers to this justification for a CPP. It acknowledges this will involve cost in order to better meet a supplier’s circumstances however it is recognised it is also likely to result in benefits such as providing for a step change in investment that better meets consumers’ demand. We agree these are the benefits which should be sought from a CPP.

8. The proposed SPA approach is based on each supplier’s information for the 2010 year and industry wide assumptions for the 2011 – 2015 years of the DPP. In the Update Paper the use of industry wide information is justified on the basis that it avoids the information asymmetries which may exist between suppliers and the Commission, should supplier specific forecasts be used for this purpose. Thus it is not proposed to implement a SPA method which uses information which is more tailored to individual suppliers. The Commission justifies this approach on the basis that the CPP provides the opportunity for suppliers to address more business specific circumstances in the instances where the industry wide forecasting assumptions under-compensate suppliers for the costs they are expected to incur.
9. This approach is also favoured by the Commission because it is deemed to be lower cost than alternative approaches which may use supplier specific information. The implication of this approach is that CPPs are likely to be required simply to justify to the Commission why a supplier’s forecast position deviates from the industry wide forecasting assumptions. For example a low growth network which is unable to generate the levels of revenue included in the Commission’s forecast, will be required to apply for a CPP simply to prove that they have lower growth than the industry average. This is inconsistent with the Commission’s acknowledged intention for a CPP to address step changes in the circumstances of a supplier. We note that the CPP information requirements have not been designed for this purpose.
10. It also appears to have the potential for half of the EDBs which are subject to the DPP having to consider applying for a CPP at the time of each reset. The combined industry wide real revenue growth, opex and capex assumptions will either over or under estimate regulatory profit for each EDB. All other things being equal, it seems reasonable to assume that about half will fall into either category. This outcome is inconsistent with the purpose for default/customised regulation and is not as a result ‘low cost’. We note that Economic Insights acknowledges that an abnormally high number of CPP applications would be counter to the intention of the CPPs.<sup>5</sup>
11. In addition, paragraph 4.29 of the Update Paper indicates that a decoupling of actual expenditure and real revenue growth provides incentives for suppliers to out-perform the price path assumptions. We agree that the CPI-X form of the DPP price path does provide such incentives. We are somewhat bemused however by the claim that the use of industry wide assumptions for the purpose of the forecast profitability under the DPP has the effect of providing incentives to outperform the assumptions. These incentives are already provided within the existing price path. In using industry wide forecasting assumptions, the model is simply introducing forecast risk, ie: suppliers are either locked into a position which reflects higher or lower revenues or costs than they expect to achieve. To some extent they are able to influence costs to improve their performance compared to the assumed forecast costs (although many EDBs would argue there is little scope for material short term cost reductions – other than deferred maintenance - given the large asset based component of costs). However real revenue growth is set by external factors (ie: customer demand) not the behaviour of the EDB. We submit that the ability of suppliers to outperform the price path will therefore be determined more by the extent to which the forecasting assumptions mirror the expected circumstances of the supplier than the efficiency gains able to be implemented over the remaining three years of the DPP.
12. We note that the Update Paper does not indicate how the proposed approach will influence the 2015 DPP reset. A supplier which is disadvantaged by the proposed approach due to divergence between actual outcomes and the Commission’s forecast outcomes and seeks remedy via a CPP should not be required to continually seek such remedies simply because the Commission’s low cost DPP approach is insufficiently

<sup>3</sup> Commerce Commission, Input Methodologies (EDBs and GPBs) Reasons Paper, 22 December 2010, paragraph 9.3.11

<sup>4</sup> Ibid, paragraphs 8.4.23 and 9.3.26 - 9.3.27

<sup>5</sup> Economic Insights, Review of the Commerce Commission’s Analytical Framework for Starting Price Adjustments, 20 April 2011, page 6

tailored to their circumstances. It is possible that those EDBs which are most at risk as a result of the approach are likely to continue to be at risk should the same approach be adopted in the future. The DPP must therefore accommodate where practical and consistent with the lower cost objectives of the DPP, forecast information relevant to each non exempt EDB or as an alternative rely on the 2010 position given the difficulty in creating a robust forecasting method at this time.

13. It is concerning that the Commission, at this late stage has abandoned its previously preferred band methodology which had, at its core, the 2010 position. This method was originally put forward by the Commission in June 2009, and restated again in August 2010.<sup>6</sup> Some eight months later an entirely new method has been put forward by the Commission, with a one month consultation window, and a final determination to be made in just over five months. This U-turn was unexpected and the deadlines unreasonably short given the magnitude of the change. The ENA, whose members include the EDBs which support this submission, invested considerable resources into testing and refining the band approach in late 2010. At no stage did the Commission indicate it was intending to abandon its band approach. The Update Paper suggests that this change was in part in response to widespread requests for more consideration of projected profitability from submitters. We dispute the claim that there was widespread demand for a method which incorporated more explicit profit projections. If there had been it seems unlikely the ENA would have gathered the support of all its members for the work it undertook on the refinements to the band approach (which did not involve explicit profit projections). We note the ENA had no mandate from its members to develop a method for forecasting supplier specific profits.

## **Alternative Model**

14. Given the difficulties in projecting profitability for the 2011-2015 DPP due to the lack of a time series of data and the inherent uncertainty in relying on a single data point (2010) for the purpose of forecasting, the ENA has developed an alternative approach. This is a modified version of the Commission's SPA model incorporating some of the elements of the proposal put forward by the ENA to the Commission in December 2010. The approach is summarised in the ENA's submission<sup>7</sup> and comprises the following key elements:

- 2009/10 ROIs are used as the basis for estimating current and projected profitability for each EDB;
- the 2009/10 disclosed values are rolled forward to project a 2010/11 ROI, and starting prices as at 1 April 2010 are adjusted such that the projected ROI for each EDB in this year equals the Commission's 75<sup>th</sup> percentile estimate of WACC plus at least one standard deviation of the ROI series as assessed in the Thomson/van Zijl report;<sup>8</sup> and
- the 2010/11 adjustment is rolled forward to 1 April 2012 using the DPP formula.

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; and
- for those EDBs whose forecast ROIs drift above or below the boundaries of the band over the forecast period, their starting prices are adjusted by an amount to reflect the NPV of earnings that is represented in the forecast ROIs exceeding, or moving below, the boundaries of the band.

<sup>6</sup> Commerce Commission, Reset of the Default Price-Quality Path for EDBs, Discussion Paper, 19 June 2009 and Commerce Commission, Starting Price Adjustments for Default Price-Quality Paths Discussion Paper, 5 August 2010

<sup>7</sup> Electricity Network Association, Submission on DPP Starting Price Adjustments and Related Amendments, 16 May 2011, Section 5

<sup>8</sup> Peter Thomson and Tony van Zijl, A statistical forecasting framework and models for the determination of starting price adjustments for default price-quality paths, 8 December 2010

15. The EDBs which support this submission have contributed to and support the further work the ENA has developed on an alternative model to the method contained in the SPA Update Paper. We believe it better meets the purpose for default/customised price quality regulation, is tailored to the specific challenges of the first DPP price reset (given the lack information available consistent with the IMs) and is consistent with the Part 4 purpose statement as providing reasonable incentives for businesses to innovate and invest, while limiting their ability to earn excessive profits by providing at least normal returns. The Part 4 Purpose Statement requires the regulatory mechanisms to apply to regulated suppliers to *limit* excessive profits and *provide incentives* to invest and innovate. We interpret this as providing at least normal returns to suppliers. The ENA's proposal is consistent with these objectives.
16. We have not replicated the full rationale and supporting explanations for the ENA's method in this submission. We support the ENA's proposal and urge the Commission to seriously consider it before moving towards its draft decisions. We note the ENA's proposed alternative model incorporates the industry wide assumptions for the purpose of the forecast ROIs, but applies them in its second stage of the alternative method, and with the addition of an upper band of two standard deviations. The EDBs which support this submission are extremely concerned at the industry wide assumptions included in the Commission's model and believe these are inappropriate for the purpose of estimating each supplier's projected profitability. The proposed band mitigates these concerns to some extent. We comment further on the forecasting assumptions below. In the remainder of this submission we set out our comments on the Commission's SPA method.
17. *The comments set out in the following two sections of this submission are made in the context of the Commission's proposed model, without prejudice to our support of the ENA's alternative approach outlined above.*

## **Measuring Current Profitability**

18. It is proposed that current profitability will be measured using information pertaining to the 2010 disclosure year, modified to be consistent with the IMs. This is the year which precedes the first year of the DPP regulatory period. We agree that for the purpose of the 2011-2015 DPP, this year is relevant to the estimation of current profitability and that given a number of the IMs set a starting position at 1 April 2009, the restatement of profit to incorporate those IMs is appropriate.
19. The 2010-15 DPP reset is unique however as starting prices are to be determined part way through the DPP period. The information available to the Commission at this time is therefore different to that which will be available for future resets. We note that the 2011 disclosure period has now ended and information could be made available for the 2011 period which would provide an additional measure of current profitability. The Update Paper suggests that time pressures have prevented consideration of this information, and that the Commission is not inclined to consider it unless it is available for all non exempt EDBs.
20. The SPA model is influenced by the starting (2010) position. This is the only information which is to be included in the model which is specific to the supplier. For this reason we believe further consideration should be given to the 2011 information where this is available and where a supplier wishes to have it included in the model. There are a number of ways in which it could be used however we suggest the most important are likely to be:
  - To illustrate abnormal features of 2010 which a supplier may wish to normalise such as unusually high or low demand or high or low costs
  - To improve the forecast revenue or costs included in the first year of the DPP period (ie: 2011) in the model. Actual revenues and costs (opex and capex) could be included in 2011 where it is able to be demonstrated that the industry wide assumptions result in material divergences from the actual experience of the supplier in that year. As the forecasting methodologies are rolled forward year on year using constant growth rates, any divergence between the Commission's forecast and actual performance in 2011 is compounded throughout the remainder of the forecast. If these were moderated based on 2011 outcomes, the likelihood of over or under compensation would reduce and the requirement for CPP applications simply to justify differences between a supplier's forecast and the Commission's forecast.

21. The original SPA Paper published in August 2010 indicated an intention to normalise the base year Return on Investment (ROI) data for abnormal items.<sup>9</sup> This aspect of the SPA appears to have disappeared from the Commission's updated approach although there is no explanation for this change in the Update Paper. We believe that accommodating further consideration of 2011 revenues and costs where provided by suppliers is consistent with the low cost objectives of the DPP and does not introduce information asymmetry concerns as the data would reflect actual not forecast performance in the same way the 2010 data does.
22. Paragraph 4.23 of the Update Paper suggests that the Commission now considers that, unlike its previous Discussion Paper, consideration of additional information to test whether 2009/10 is representative of supplier circumstances is not required. This is because the supplier is able to apply for a CPP if it is not. We do not accept that this is consistent with the low cost objectives of the DPP. Forcing a supplier to apply for a CPP simply because the supplier specific data used in the DPP model is not representative of that supplier's current performance is not a low cost outcome.
23. We also note that it is not clear how the Commission is intending to use the dataset from the section 53ZD information request for revised 2010 regulatory profit information in its SPA Model. This issue was raised in the responses to the draft section 53ZD request.<sup>10</sup> Further consultation should be provided for, in this respect, before the draft decisions are published.

## ***Measuring Projected Profitability***

24. As noted above the SPA model is influenced by the 2010 starting position. It is also strongly influenced by the industry wide forecasting assumptions which are proposed to be used for all non-exempt EDBs to project the revenues and costs for each supplier over the five year 2011 -2015 DPP. The present value of the difference between the Commission's forecasts of revenues and costs for each non-exempt EDB forms the basis of the proposed SPAs. Paragraph 1.6 of the Update Paper indicates that the SPAs are the main way of tailoring the DPP to each supplier, given the constant rate of change (X factor) adopted for the sector. However it is proposed that (with the exception of the 2010 starting position) industry wide assumptions will be applied to all EDBs in order to calculate the SPAs. This appears contrary to the objective of tailoring the DPP to individual business circumstances as set out in the Update Paper.
25. The proposed approach is a significant departure from the approach set out in the Commission's earlier June 2009 and August 2010 Discussion Papers. It is not entirely clear why the Commission has decided to modify its proposed approach in such a significant way. The Update Paper includes little reference to the previous papers. Paragraph 2.4 of the Update Paper indicates that submitters generally considered the band approach embodied in the August 2010 paper placed insufficient emphasis on each supplier's projected level of profitability. As stated previously, as far as we are aware this was not a general view of submitters, and instead submitters were interested in exploring possible refinements and improvements to the band approach. This view was enforced by the ENA's subsequent commissioning of Statistical Research Limited to investigate statistical methods which may be used to determine the width of the band(s).
26. We note the Commission's concerns regarding the use of supplier specific forecasts for the purpose of the SPA analysis. We believe there are alternative sources of information which may be used to inform the appropriate forecasting assumptions for each supplier which are not exposed to potential over or under statement and do not require the level of data verification required for a CPP. The Update Paper indicates that the Commission is undertaking more work on the forecasting assumptions. We are also considering this aspect of the method further and expect to provide an additional submission in this respect in time for the extended deadline of 23 May. In the interim we make the following observations:
  - Paragraph 2.15 of the Update Paper suggests that the starting price adjustments are necessary to provide all EDBs with an opportunity to earn a normal rate of return over the duration of the regulatory period, based on the common set of assumptions for cost and real revenue growth. This

<sup>9</sup> Commerce Commission, Starting Price Adjustments for Default Price-Quality Paths Discussion Paper, 5 August 2010 paragraphs 4.4 - 4.6, page 20

<sup>10</sup> For example, Electricity Networks Association, Submission on Draft Information Request and Process Update for DPP Starting Price Adjustments, 28 February 2011, paragraph 8

conclusion is only valid if the EDB's actual revenue and costs over the DPP period align with the Commission's forecasts.

- The model is most sensitive to the real revenue growth forecast assumption. This is to some extent mitigated by the use of a similar assumption for forecasting opex; however this does not fully insulate businesses from the impact of the growth assumptions.
- The real revenue growth assumptions are derived in part from historical industry output measures (throughput, connections and system capacity). These have been derived from the non exempt EDB dataset. To the extent a supplier's historical trend diverges from the non exempt EDB industry subset, they will either be penalised or advantaged.
- Due to the divergence in the scale of non-exempt EDBs the probability of diverging from the industry trends is higher for smaller EDBs than the larger EDBs. This is because the data series are created by adding together the output of all non exempt EDBs. The output trends of the larger EDBs therefore dominate the data series used. This has the characteristics of benchmarking which we note is inconsistent with section 53P(10) which sets out the requirements for resetting starting prices, rates of change and quality standards for the DPP.
- Forecast capex growth assumptions are to be derived from industry wide trends from 2010 AMPs. 2011 AMPs have now been published, and these were published before the Commission's revised method was made available. 2011 data is more up to date and can be used at no additional cost and at no further risk of 'gaming' than the 2010 data given the model has not been released at the time the AMPs were published.

27. In addition we note that the Update Paper does not indicate how the proposed approach will influence the 2015 DPP reset.

### ***Proposed Starting Price Adjustment Process***

28. The Update Paper suggests that the SPAs are to be applied to the price path by adjusting Allowable Notional Revenue at the commencement of the 2012/13 assessment period. We agree with this approach in principle. We also support the proposal that this is to be applied at an aggregated level (not at an individual price level) as this is consistent with the weighted average price cap form of the DPP.

29. The Update Paper outlines two possible scenarios for the SPA, as follows:

- one which is forward looking, ie: makes an adjustment at 1 April 2012 for the difference between the Commission's forecast of revenues and costs over the remaining three years of the DPP, or
- an alternative which makes an adjustment at 2012 which reflects the difference between the present value of the Commission's forecasts of revenues and costs over the entire five year DPP period, commencing 1 April 2010.

30. The Update Paper indicates a preference for the first option (the three year adjustment) because it avoids the retrospective nature of the alternative which the Commission indicates is more consistent with providing incentives to invest. We agree with this view in principle although we note that it will result in some businesses earning below normal returns over the DPP period and others earning above normal returns. As the IMs were not available at the commencement of the DPP, we believe this is appropriate as the 2012 adjustment on a forward looking basis is a reflection of the IM consultation and implementation processes. Prior to 2012, EDBs were unable to set prices on a consistent basis with the IMs. It is therefore appropriate that the impact of the IMs on prices should be introduced from 2012 onwards without claw back.

31. We note that some of the EDBs which support this submission are likely to be granted positive SPAs. Most of these are consumer owned, and therefore any additional revenues earned following the SPA will ultimately be returned to their owners. The consumers of those EDBs have already benefited from lower prices in lieu of higher dividends during the initial years of the DPP.

32. In addition the Update Paper considers circumstances where alternative rates of change may be used to spread the impact of the SPA across more than one year. Section 53P(8) provides for this in the event of financial hardship for the supplier or price shock for consumers. The Update Paper proposes that the

Commission will consider proposals for alternative rates of change from suppliers in the event of financial hardship where:

- The supplier is expected to be limited in its ability to finance its reasonable investment needs (with reference to the CPP expenditure objective) and/or meet its debt repayment obligations, and
  - It is not reasonable for the supplier to address its financial constraints by reducing its gearing by issuing equity, reducing expenditure and/or reducing dividends.
33. We note that the DPP includes quality limits, and the assessment of the requirement for an alternative rate of change must include the ability of a supplier to meet its DPP quality limits. This is of direct relevance to the ability to reduce or defer expenditure, and could have implications for future DPP periods. For example a reduction in planned maintenance will reduce planned outages. The lower level of outages in the current DPP may translate into lower reliability limits for future DPPs. However reduced maintenance expenditure is likely to result in higher unplanned outages. These are unlikely to occur in the current DPP period but are more likely in future DPP periods. For this reason we do not support the proposal for suppliers to reduce short term expenditure in order to meet the SPA requirements.
34. The Commission proposes assessing likely price shock to consumers on a case by case basis, using a threshold of a 10% increase in line charges as a trigger for such investigation. We believe the same threshold should apply to revenue reductions. However the Commission should be careful to avoid intervening in the weighted average price cap form of the DPP price path. Any alternative rate of change should be limited to the total price path for each supplier, and not be specified at the tariff, or load group level which would be inconsistent with the specification of price for the DPP.
35. We agree that any alternative rate of change should be combined with a SPA in 2012, thus sharing the impact of the SPA between the two mechanisms. A portion of the SPA should be introduced in the first year to maintain consistency with other affected suppliers. The relative proportions and rates of change can be specified on a NPV neutral basis within the current DPP period. We also support consideration of step changes in the rates of change where these better match the expenditure requirements of the supplier.
36. We note that the proposed process for setting alternative rates of change as set out in Table 3 of the Update Paper requires suppliers to prepare evidence and propose an NPV neutral solution based on the illustrative starting price adjustments in the Update Paper. We submit this is premature and an unreasonable request within the time permitted to respond to the paper. The results presented in the Update Paper are illustrative and subject to consultation, new input data and further work to be undertaken by the Commission. The appropriate time for suppliers to consider these issues is following the draft decisions, once the method and outcomes are more certain.

### ***Other Proposed Changes to the DPP***

37. It is proposed that the DPP determination is updated for a number of changes in addition to the proposed SPA. This is in effect a mid period change to the DPP. The DPP processes and rules IM sets out the circumstances under which a DPP may be reopened. The proposed changes to the DPP however do not reflect circumstances covered by the reopener provisions in the IM.
38. Section 53ZB(1) limits a DPP from being reopened if an IM changes with the exception of changes to IMs which may arise as a result of merits appeals, subject to a materiality test (section 53ZB(2)). However section 54K(3) provides the Commission with a one off opportunity to change the 2010-15 DPP as a result of the first IM determinations, if had those IMs applied at the time the DPP was set, the DPP would have been materially different. This must be done within 9 months of the publication of the IMs and in accordance with section 53P. Section 53P(2) requires the Commission to consult with interested parties when resetting the DPP starting prices, rates of change and quality standards. Section 52Q specifies that any amendment of a section 52P determination may be made in a material way only after consultation with interested parties, and in a non material way without consultation.
39. The Commission proposes to exercise its powers under section 54K(3) to make a number of changes to the 2010 DPP which arise from the IM determinations. These include amended definitions of:

- Price
- Posted discount
- GST
- Electricity distribution service
- CPI
- Pass through cost (and its components)
- Recoverable cost (and its components)

40. In addition, the DPP price path compliance formula is to be amended to reflect the new definitions of pass through and recoverable costs. This proposal appears reasonable.
41. We note however that the DPP determination includes careful wording in the definition of the transmission component of pass through costs to capture the limited circumstances where an EDB has no contractual relationship with Transpower and instead receives is Transpower related charges as a pass through from a neighbouring network. The relevant wording in the DPP determination is as follows:

*“Transmission charge means any amount in respect of:*

*(a) Electricity Lines services provided to a Non-exempt EDB in respect of the Transmission System in accordance with the Transmission Pricing Methodology*

42. The difference in the IM 3.1.3(1) definition of Recoverable Cost is that it assumes payment to Transpower, which is not always the case. The DPP provision should be retained, and we suggest the IM should be amended to reflect these circumstances.
43. In order to implement the recoverable cost definition, there is to be additional guidance included in the DPP regarding the evidence to be supplied to support some components of recoverable costs, namely avoided transmission charges arising from a purchase of assets from Transpower. The Commission’s proposed approval process for the avoided transmission charges specified in 3.1.3(1)(e) of the IM is for the evidence to be provided and reviewed as part of the annual DPP compliance statement process. This is an ex post approval and will be based on evidence to support the asset acquisition and the avoided Transpower charges which arise. We support this approach although we note there remains some uncertainty as to the Commission’s likely actions after the review of the Compliance Statement. If the Commission were to determine a different recoverable cost, then this could lead to an unintentional breach of the price path, given the supplier will have included their own assumptions in their prices. More guidance is required on the Commission’s intended actions under these circumstances before this approach is incorporated into the DPP.
44. The IM permits the EDB to recover the avoided Transpower charges for a period of five years (refer 3.1.3(4)). The Update Paper proposes that the avoided transmission charge is limited to the same nominal annual charge avoided in the first year for each of the subsequent four years (after adjusting for partial period allowances in year one where relevant). We believe this proposal is inconsistent with the IM and therefore do not support it. The IM states that the EDB is able to recover the avoided Transpower charges for a period of five years. It is highly unlikely that Transpower charges will remain constant in nominal terms for spur assets over a period of five years. Any limitation which caps the avoided transmission charge at the first year level in nominal terms is likely to understate the benefit to EDBs which is inconsistent with the incentive objectives of this component of recoverable costs. As the transmission pricing methodology is transparent and known annually in advance, it is possible for the avoided Transpower charges to be estimated each year. These can be audited against the methodology.
45. The Update Paper presupposes a complexity in calculating the avoided transmission component which in our view is unwarranted. Before making any purchase of Transpower’s assets it is expected that EDBs will have undertaken detailed cost benefit analysis which will include estimation of the avoided Transpower charges for a reasonable forecast period. These can be confirmed, and if necessarily revised for DPP compliance purposes once Transpower updates its annual pricing parameters.

## ***General***

46. We trust this submission provides useful input for the Commission in finalising its SPA approach. We would be happy to answer any questions you may have regarding this paper.

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