

**Submission on 2010-15 Default Price-Quality Path  
for Electricity Distribution Businesses**

**Draft Decisions Paper**

From the Electricity Networks Association

24 August 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) 2011 Draft Decision, issued in July, to reset the default price-quality path (DPP) for non-exempt electricity distribution business (EDBs).

### *Approach to DPP reset*

2. The Commission has adopted an approach to resetting the DPP whereby three months out from the date by which this determination needs to be made the method for making this determination has not been finalised, and the Commission is simultaneously finalising the method, the model, and the data to populate the model. The ENA considers this approach is contrary to the intention of Part 4 to improve the certainty of regulatory decision making.
3. The ENA recommends:
  - That the Commission ensures the method it uses to reset the DPP in the future is determined in advance of implementing that method.
  - That the Commission determine the method for resetting the DPP in the future as an input methodology.

### *Inclusion of a margin for error*

4. The Commission's proposed SPA methods prior to April 2011 incorporated explicitly a margin for error. An explicit margin for error was excluded from its April and July 2011 proposed methods. The ENA has consistently submitted a margin of error is required, on the basis of asymmetrical economic effects of error (providing for an inadequate return on investment has a greater negative economic consequence than providing for a return in excess of that required to attract investment), and the absence of a low cost error correction mechanism. The Commission believes the customised price/quality path (CPP) to be a low cost error correction mechanism but the ENA and EDBs do not agree. The costs to undertake a CPP are substantial, uncertainty of outcome is high and the potential remedies available within this DPP are limited due to the restricted opportunity for CPP applications to be made. If EDBs do not consider the CPP to be a low cost error correction mechanism it will not be used as such.
5. The Commission implicitly allows for a margin of error in its discussion of an EDB's weighted average cost of capital (WACC). However, it incorrectly uses a recent estimate of the WACC in this discussion (7.70%), rather than an estimate of an EDB's WACC derived using the relevant input methodology (IM, at 8.77%). The ENA supports the Commission's (implicit) inclusion of a margin for error, but it needs to be applied to the correct estimate of an EDB's cost of capital.

6. The ENA recommends:
  - That the Commission uses its estimate of 8.77% for the WACC of EDBs when taking into account the cost of capital in making this DPP determination; and
  - That the Commission incorporate in its SPA method a margin for error that is applied to its WACC estimate of 8.77%.

***Delayed development of the method***

7. The iterative development of the proposed method over the past two years has resulted in a less than satisfactory outcome where there now remains insufficient time to implement the method in an acceptable way. The 2011 Draft Decision does not put forward a final method and the information requirements for the proposed model to implement the proposed method are unable to be properly met given the impending deadline.
8. Accordingly, in this submission we have considered the most significant issues within the proposed model and input assumptions and have submitted the changes that we consider need to be made to address the most important anomalies.
9. Looking forward to future resets, we would be very disappointed if in about three years we were in a similar position in the lead up to the DPP reset to apply from April 2015. The ENA submits that it is necessary to have a clear view of the method to be applied well before the decision is to be made, in order to ensure the modelling to apply that method can be developed with sufficient rigour, and to allow time for the necessary data and forecasts to be acquired or compiled.

***Ad hoc change to discounting***

10. In its most recent model the Commission has attempted to introduce an additional level of precision in its discounting approach, by assuming that all revenues and some costs (opex) occur on average midway through the year, but other costs (tax, depreciation, revaluation and return on assets) occur at the end of the year.
11. If the Commission wishes to move away from the current ROI measure (which has been used in its draft SPA models up to the July version and in its previous investigations into electricity and gas) it should do so only after working through all relevant cash flow considerations and subjecting that analysis to consultation. There is insufficient time to do so for this SPA and the ENA submits it is inappropriate for the Commission to proceed with its proposed ad hoc change as proposed. Accordingly the ENA recommends that the Commission assess forecast profitability as a year end measure for the purpose of its SPA model.

### *Model inputs and assumptions*

12. That changes are required to the proposed data and assumptions to address the most significant deficiencies in the proposed approach for the forthcoming reset, including that:
  - forecasts should be derived from the most recent available source of data
  - the Commission acquire up to date Electricity Authority throughput forecasts to be based on GDP and population projections consistent with those used elsewhere in the model, or as an alternative use GDP and population rates of growth to project variable revenue growth acknowledging that alternative solutions may be required for those which price on a GXP basis;
  - GXP rather than regional throughput forecasts are used for each network;
  - sector price index forecasts are acquired and used in the model; and
  - EDBs are able to propose alternative X factors, on a NPV neutral basis.
13. In addition the proposed compliance formula for determining allowable notional revenue for the 2012/13 year should be amended to incorporate the  $(R_{2012} - NR_{2012})$  term from the existing DPP price path.
14. Further that  $R_{2015}$  incorporate an adjustment factor to address divergence between assumed and actual  $\Delta D$  term in the proposed compliance formula. This is required to ensure the  $AR_{2013}$  is able to be achieved by all EDBs.

### *Other proposed changes to the DPP*

15. The ENA also submits that:
  - the proposed DPP determination include avoided transmission recoverable costs for existing investments or activities which substitute for the transmission system, consistent with the current DPP;
  - the Commission should consider any CPP proposal received at any time other than the January window, with the objective of making a CPP determination as early as practicable, and that CPP proposals in response to a catastrophic event should be able to be considered in the final year of the DPP period;
  - in the event of a non amalgamation transaction, EDBs submit self assessments in the year of the transaction against the existing DPP, and in addition notify the Commission of the transaction where the following criteria are met;

- the non-exempt EDB's value of assets associated with the provision of electricity distribution services increases or decreases by more than 10% within an assessment period, as a result of a transaction; or
- the non-exempt EDB's notional revenue associated with the provision of electricity distribution services increases or decreases by more than 10% within an assessment period, as a result of a transaction.
- amendments are included to clarify the processes, compliance and reporting requirements for approval for recoverable costs.

## 1. Introduction

16. This submission from the Electricity Networks Association (ENA) is in response to the Commerce Commission's (the Commission's) 19 July 2011 draft decision to reset the DPP applying to non-exempt EDBs (2011 DPP Draft Decision).
17. In this submission we comment on the context and approach the Commission has taken to reset the DPP and respond to the proposed starting price adjustments and other proposed changes to the DPP. As the ENA represents all EDBs our responses in this submission are on points applicable across all non-exempt EDBs and we do not touch on issues related to individual EDBs. The submission is structured along the following lines:
- Section 2 comments on the context and approach to the DPP reset reflected in the 2011 Draft Decision;
  - Section 3 assesses the proposed method to estimate current and projected profitability and recommends possible improvements to the proposed method;
  - Section 4 considers the compliance formula to implement the proposed SPAs and possible improvements to that formula; and
  - Section 5 considers the other DPP amendments proposed in the 2011 DPP Draft Decision and possible improvements to them.

## 2. Context and approach to DPP reset

18. The 2011 DPP Draft Decision follows three previous consultation papers the Commission has issued on a possible method for undertaking starting price adjustments (SPA) – in June 2009 (the 2009 SPA paper), August 2010 (the 2010 SPA paper) and April 2011 (the 2011a SPA paper).<sup>1</sup> In addition, the Commission undertook additional consultation on possible refinements to the

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<sup>1</sup> *Reset of default price-quality path for electricity distribution businesses; Discussion paper*; Commerce Commission, 19 June 2009; *Starting price adjustments for default price-quality paths; Discussion paper*; Commerce Commission, 5 August 2010; and *2010-15 Default Price-Quality Path Starting Price Adjustments and other Amendments; Update paper*, Commerce Commission, 11 April 2011

DPP in August 2011.<sup>2</sup> The ENA has provided substantial responses to each of these consultation documents.

19. The 2011 DPP Draft Decision sets out the scope of the proposed reset in paragraph 1.36 as follows:
  - *Resetting maximum allowable prices in 2012/13 such that each EDB is projected to earn a normal rate of return between 2012/13 and 2014/15*
  - *Resetting the maximum allowable rate of change in prices applying to all EDBs to reflect the new definition of CPI specified under the IMs*
  - *Resetting the maximum allowable rate of change in prices applying to specific EDBs where this is desirable to minimise potential price shocks to consumers*
  - *Making other amendments to the 2010-2015 DPP determination to ensure it is consistent with the IMs.*
20. The draft decision includes no proposed changes to the DPP quality path or the industry wide X factor component of the DPP price path.
21. The 2011 Draft Decision sets out a draft reset of the DPP due to be gazetted no later than 20 October 2011 and to apply from April 2012. It includes a draft method for undertaking the DPP reset, and populates that draft method with draft data provided by EDBs and estimates undertaken by the Commission. Thus three months out from when the DPP reset decisions are to be gazetted EDBs still do not know for certain what method will be used to undertake the reset, or how data may be modified to populate whatever method is used. The ENA considers this approach to the reset is contrary to the intention under Part 4 to improve regulatory certainty.
22. Of particular concern is that the Commission has not settled the method it intends to use for the reset prior to populating that method with data. By developing a draft method and populating that method with draft data contemporaneously creates the impression the Commission is reserving to itself the discretion to engineer the method to deliver pre-determined outcomes. The Commission's discussion in both the 2011 Draft Decision and the 2011a SPA paper establishing that the net effect of the changes is neutral on consumers (in fact a small decrease is predicted) tends to support the impression that the Commission has a target of no overall price increases. The impact on draft outcomes arising from changes in method at this late stage are not just academic

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<sup>2</sup> 2010-2015 Electricity Distribution Default Price-Quality Path Refinements Discussion and Draft decisions paper, Commerce Commission, 13 August 2011

– some EDBs have experienced downward shifts of up to 10% in their prices relative to the method put forward in the 2011a SPA Paper.

23. The ENA wishes to highlight that retaining such discretion in this way comes at a very high cost in terms of the sector being able to build confidence in the regulatory decision making process. Furthermore, this approach has failed to make use of the opportunity the Commission had, subsequent to the very large investment in 2009/10 in input methodologies (IMs), to embed a step change in the level of certainty in its regulatory decision making.
24. The ENA has stated previously that the method to reset the DPP is required to be, and should be an IM.<sup>3</sup> If the Commission had taken that approach the lingering uncertainty with respect to method would have been addressed some time ago. The ENA considers the current unsatisfactory situation highlights the desirability of the DPP reset method being an IM. The ENA recommends for the next DPP reset the Commission ensures the method is established well in advance and that it reconsiders issuing this method as an IM.

### **Recommendation**

25. That the Commission ensures the method it uses to reset the DPP in the future is determined in advance of implementing that method.
26. That the Commission determine the method for resetting the DPP in the future as an input methodology.

## **3. Estimating current and projected profitability**

27. The Draft Decision sets out proposed SPAs for all non-exempt EDBs, to be implemented from 1 April 2012 for the remainder of the DPP period, ie: until 31 March 2015. For some EDBs, differential rates of change are also proposed, to apply for the final two assessment periods of the current DPP. In this section of the submission we consider:
  - the application of the proposed model within the DPP/Customised price-quality path (CPP) framework;
  - the Commission's calculations for determining 2012/13 allowable revenue for each non-exempt EDB; and

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<sup>3</sup> The reasons for this view are set out in the ENA letter of 23 July 2010 headed *Starting price adjustment methodology*

- the Commission’s approach to forecasting projected profitability for each non-exempt EDB.

## The need for a margin for error

28. In the 2009 and 2010 SPA papers the Commission proposed a SPA method which explicitly recognised the need for a margin for error and incorporated such a margin. In the 2011a SPA paper a margin for error was removed from the method.<sup>4</sup> The primary reason for the Commission’s change of view appears to be its belief that the CPP provides a low cost error correction mechanism.
29. The ENA has been consistent in its SPA submissions that a margin of error is required in the SPA method. The reason for a margin for error is the asymmetrical effects of error (i.e. providing for an inadequate return on investment has greater negative economic consequences than providing for a return above that required to attract investment) and that there is no low cost error correction mechanism. The ENA has also provided the Commission an expert report (the Thomson/van Zijl report) on the statistical analysis of the movement in EDBs’ ROIs over recent years, the results of which could be used to determine the level of a margin required in order to meet a defined level of confidence in the SPA method.<sup>5</sup>
30. While the Commission considers the CPP could be used as a low cost error correction mechanism the ENA has submitted previously it is not viewed that way by EDBs, due to the high expected costs of undertaking a CPP and the very substantial uncertainties of outcome. If EDBs do not view the CPP as a low cost error correction mechanism it will not be used in that way. In addition there are only very limited CPP remedies available to the proposed DPP due to the shorter three year regulatory period, and the restricted CPP application windows proposed. We address this point further later in the submission.
31. Although the Commission appears in the 2011 Draft Decision to not support the use of an explicit margin for error in its method, it does implicitly accept the presence of a margin for error in its method. The Commission sets out this view as follows (paragraph 2.43, .44 & .47):

*The risk of setting the DPP too low for any individual EDB is limited at present because we have provided all EDBs with a rate of return for the next three years that is significantly higher than investors currently require for*

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<sup>4</sup> See ENA’s comments on these earlier papers in paragraphs 77 – 81 of *Submission on DPP Starting price Adjustments and Other DPP Amendments*, the Electricity Networks Association, 16 May 2011

<sup>5</sup> Ibid, paragraph 84

*that period. This is because we have reset starting prices on the basis of the 8.77% nominal return that investors required, on a forward looking basis, in November 2009 for the 2010-15 period, not the rate of return that investors require now. This fall has been caused by changes in the risk-free rate and the debt premium.*

*Importantly, the change in the required nominal return is not due to a change in inflation expectations. Because inflation expectations have not changed significantly since November 2009, the rate of return that we are allowing after adjusting for inflation is also 1 percentage point higher than suppliers require. Table 2.2 below shows that inflation expectations that correspond to a WACC of 8.77% for 2010-15 are very similar to the inflation expectations that correspond to a WACC of 7.70% for 2012-17.*

*... We therefore consider that it would be inappropriate to include an additional margin when resetting the DPP.*

32. In the last sentence quoted above the Commission rejects including an “additional margin” on the basis that using a WACC estimate of 8.77% allows for a margin relative to the Commission’s more recent estimate of WACC at 7.70%. Thus the Commission implicitly provides for a margin for error as an increment to its most recent estimate of WACC. ENA supports the incorporation within the SPA model of a margin for error, but considers the Commission has applied it to the incorrect estimate of WACC.
33. The IM that sets out the way in which the Commission is to estimate WACC and take account of the cost of capital in a DPP determination states that (with all IM references to Part 4 Subpart 1):<sup>6</sup>
  1. The WACC in relation to DPPs is to be estimated for a 5 year period (clause 4.1.1 (b));
  2. The risk free rate and debt premium are to be calculated from data from each business day in the month 8 months prior to the regulatory period (clause 4.1.3 & 4.1.4 (3) ); and
  3. Where the Commission takes into account the cost of capital in making a DPP determination the Commission will use the 75<sup>th</sup> percentile estimate of the WACC (clause 4.1.9 (1)).

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<sup>6</sup> *Input methodologies determination applicable to electricity distribution services pursuant to Part 4 of the Commerce Act 1986 (the Act), Decision 710, Commerce Commission, 22 December 2010*

34. When applying the above IM to this SPA the “regulatory period” runs from April 2010 to March 2015 (as this SPA does not commence a new “regulatory period”). Thus the month referred to under point (2) in this circumstance is August 2009, that is the month 8 months prior to 1 April 2010. It follows the WACC estimate to be used for this SPA needs to be undertaken using data from August 2009. The Commission’s 75<sup>th</sup> percentile WACC value of 8.77% is derived consistent with this approach, as set out in its Decision 718.<sup>7</sup>
35. Point (3) above obliges the Commission to use its estimate of the 75<sup>th</sup> percentile WACC when taking into account the cost of capital in making a DPP determination. Thus it follows in this circumstance the Commission is obliged to use the 8.77% value when taking into account the cost of capital in this SPA determination. This is in contrast to paragraph 2.43 & .44 where the Commission takes into account a different WACC value (i.e. the 7.7% derived using more recent data inconsistent with the IM). The Commission does not explain the basis for it using the 7.7% WACC value when taking into account the cost of capital in this determination; the ENA considers there is no basis for doing so.
36. The ENA considers the above analysis has two implications for the 2011 Draft Decision:
- The IMs require the Commission to use the value of 8.77% for (vanilla) WACC when taking into account the cost of capital in this determination, and does not provide for the Commission to take into account any other estimate of WACC (e.g. the 7.7% it cites in paragraph 2.44) when making a DPP determination; and
  - The Commission should adopt a margin for error in its SPA method for the conceptual reasons cited above (asymmetric economic effects of error and the absence of a low cost error correction mechanism), and also to be consistent with its implicit approach referred to above by which it considers it is allowing for a margin of error (but references the margin to the incorrect estimate of WACC for this determination).

### **Recommendation**

37. That the Commission uses its estimate of 8.77% for the WACC of EDBs when taking into account the cost of capital in making this DPP determination; and
38. That the Commission incorporate in its SPA method a margin for error that is applied to its WACC estimate of 8.77%.

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<sup>7</sup> See paragraphs 23 – 36 of *Determination of the Cost of Capital for Services Regulated under Part 4 of the Commerce Act Pursuant to Decisions 709, 710, 711, 712 and 713*, Commerce Commission, 3 March 2011

## Calculating allowable revenue

39. The Commission's model (2012-13 Price Reset Model Draft Decisions July 2011.xls) which supports the draft decision for SPAs for each non-exempt EDB differs to the previous models put forward by the Commission in August 2010 and April 2011. The key differences include:
- Inclusion of source data for each EDB for the 2010 disclosure period derived from the March 2011 s53ZD information requests and related modifications to the forecast logic;
  - Modification of the forecasting assumptions applied to derived future revenue, capex and opex for each EDB;
  - Modification of the forecast CPI;
  - Introduction of differential X factors for some EDBs; and
  - Changes to the discounting of revenues and opex.
40. For some EDBs these changes have resulted in outcomes which are significantly different to those presented in the April 2011 SPA Paper, for others the cumulative changes have had very little impact when compared to the earlier analysis.
41. The ENA acknowledges that it is reasonable for the revised model to include more accurate data which was not available in April. It is also reasonable for the suggested improvements with regards to the forecasting assumptions to have been considered and refinements made. However the fundamental changes to the logic in the model, particularly with respect to the discounting approach, have occurred at a very late stage in the consultation process and have introduced an approach which we understand has not been applied by the Commission previously in its investigations in either the electricity or gas sectors.

### ***Delayed development of method has compromised implementation***

42. The iterative development of the proposed method over the past two years has resulted in a less than satisfactory outcome where there now remains insufficient time to implement the method in an acceptable way. The 2011 Draft Decision does not put forward a final method and, it is the ENA's view that the information requirements for the proposed model to implement the proposed method are unable to be properly met given the impending deadline.
43. The ENA submits that the proposed approach for resetting the DPP price path has been compromised by the many (and late) changes which have been made to the method and the proposed supporting models. This has resulted in insufficient time and resources employed in developing the information required to populate the currently proposed model. We believe that much of the

information used in the Draft Decision is not fit for purpose as we demonstrate throughout the remainder of this submission. Good regulatory practice requires clear thinking, robust models and good quality information which is relevant to the task. In our view this requires development of a method first, followed by the development of a model to implement that method inclusive of the acquisition, and if necessary development, of necessary data. This has not been the case throughout this process and accordingly the outcomes are now compromised by poor data.

44. EDBs are now faced with a pending DPP price path reset with little time available for the Commission to correct the deficiencies which have arisen from the less than satisfactory process outlined above. Accordingly, in the following paragraphs we have considered the most significant issues within the proposed model and input assumptions and have submitted the changes that we consider need to be made to address the most important anomalies.
45. Looking forward to future resets, we would be very disappointed if in about three years we were in a similar position in the lead up to the DPP reset to apply from April 2015. The ENA submits that it is necessary to have a clear view of the method to be applied well before the decision is to be made, in order to ensure the modelling to apply that method can be developed with sufficient rigour, and to allow time for the necessary data and forecasts to be acquired or compiled.

***Ad hoc change to discounting should be reversed***

46. The model generates the Commission's estimate of the future revenues and costs of each non-exempt EDB to 2015. The information used is derived from the 2010 year, combined with forecasting assumptions. 2011 data which is now available is not used, nor are the EDB's own forecasts of future revenues and costs.
47. In addition, projected costs include depreciation, return on assets and tax less annual revaluations. In order to project these values for each EDB, it is necessary to project the value of the regulatory asset base (RAB), tax asset base, deferred tax balance, and other tax values such as timing differences and tax adjustments. In order to generate the required forecasts of these variables, the model makes a number of simplifying assumptions (relative to the relevant IMs), for example in the depreciation calculations and the tax provisioning. Accordingly the forecasts are not fully consistent with the IMs for regulatory tax or asset valuation. The Commission justifies this approach on the basis that the projected profitability estimates under the DPP are not intended to be as rigorous as under a full building block analysis, as would be expected for a CPP for example.
48. However, in its most recent model the Commission has attempted to introduce an additional level of precision in its discounting approach, by assuming that all revenues and some costs (opex) occur on average midway through the year, but

other costs (tax, depreciation, revaluation and return on assets) occur at the end of the year.

49. By introducing differential timing assumptions, the Commission appears to be trying to create a cash flow model from what is an annual profitability measure. The cash flow model however is incomplete (e.g. it does not include working capital) and is based on a variety of assumptions that are untested (e.g. that revenues are weighted toward the first half of the year, that tax is largely payable at the end of the year, and that capex and opex are expended evenly throughout the year).
50. In relation to omitting working capital, the ENA submitted in the development of the IMs that working capital should be included in the RAB, but this was rejected by the Commission. If the Commission now wishes to convert the IM based information into a cash flow model the arguments for include working capital are even stronger and the ENA is unable to understand why the Commission has omitted it from its proposed approach to cash flow modelling.
51. In relation to assuming tax payments fall at the end of the regulatory year, the Commission provides no evidence for this. It is usual for provisional tax payments to be made throughout the year, plus some EDBs have tax years that are not the same as the regulatory year. This assumption appears to be without foundation.
52. Further, the proposed cash flow model approach is not consistent with regulatory profit measurement under the Information Disclosure Requirements (IDRs), and the Commission did not propose such a change to the way in which regulatory profit is measured at the recent IDR review workshop. This proposed approach would therefore create a disconnect between the ROI measure reported in IDRs and the ROI measure used in SPA modelling.
53. The 2011 Draft Decision provides little justification for this proposed change to the discounting of some, but not all components of the ROI calculation. The current specification of regulatory profit is a year end measure, which is consistent with the RAB IM (in particular in the manner in which depreciation and revaluations are accounted for). Given the objective of the draft decision is for each EDB to expect to be able to earn normal rates of return, the ENA submits that this should be assessed as a year end measure with all components of profit discounted equally.
54. If the Commission wishes to move away from the current ROI measure (which has been used in its draft SPA models up to the July version and in its previous investigations into electricity and gas) it should do so only after working through all relevant cash flow considerations (inclusive of working capital and tax), checking its assumptions against available data (e.g. the spread of revenue through a year, capex and opex profiles, etc), and subjecting that analysis to consultation. There is insufficient time to do so for this SPA and the ENA

submits it is inappropriate for the Commission to proceed with its proposed ad hoc change as proposed.

### **Recommendation**

55. That the Commission assess forecast profitability as a year end measure for the purpose of its SPA model.

### **Forecasting projected profitability**

56. The 2011 DPP Draft Decision now includes a number of significant changes from those proposed in the April SPA Paper with respect to the derivation of projected profitability. In particular real revenue growth is now projected for each EDB by applying assumptions for:

- Revenue weights (provided by each EDB);
- Variable real revenue growth (derived from regional throughput growth forecasts);
- Fixed real revenue growth (derived from regional population growth forecasts); and
- Capacity revenue growth (derived from regional GDP growth forecasts).

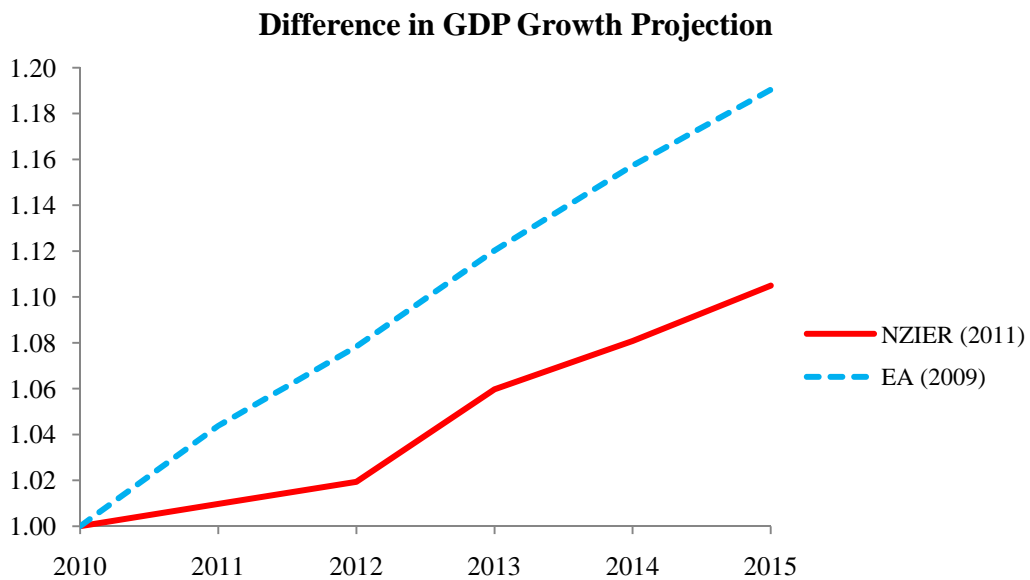
57. In addition, projected opex and capex costs are derived for each EDB by applying assumptions for:

- Input price indices (labour cost index (LCI), producers price index (PPI) and capital goods price index (CGPI));
- Growth in real capex for each EDB (derived from 2010 AMPs);
- Labour and material input weights for opex price inflation; and
- Real revenue growth assumptions for opex growth (from above).

### ***Inconsistencies between forecast data sources***

58. The forecasting assumptions noted are derived from a range of sources and reflect forecasts made at different points in time. This introduces inconsistencies in the assumptions applied in forecasting the various components of the revenues and costs for each EDB. As a matter of principle the ENA submits that all forecasts should be derived from the most recent available series for each source (with the exception of the CPI forecast which appropriately has been derived from a data series which is consistent with the DPP cost of capital). Where updated forecasting information is available prior to the final determination it should be used.

59. The range of forecast data sources also exhibit notable inconsistencies. The most significant inconsistencies are in the real revenue growth forecast which is made up of forecasts of electricity throughput (kWh), population and GDP. The throughput forecasts were published in December 2009 by the Electricity Commission.<sup>8 9</sup> The population forecasts were published by Statistics New Zealand in 2011 and the GDP forecasts by NZIER in 2011. Underpinning the EA's throughput forecast however is GDP and population forecasts which differ to the more recent forecast used by the Commission for the other components of real revenue growth. The following charts illustrate the differences.



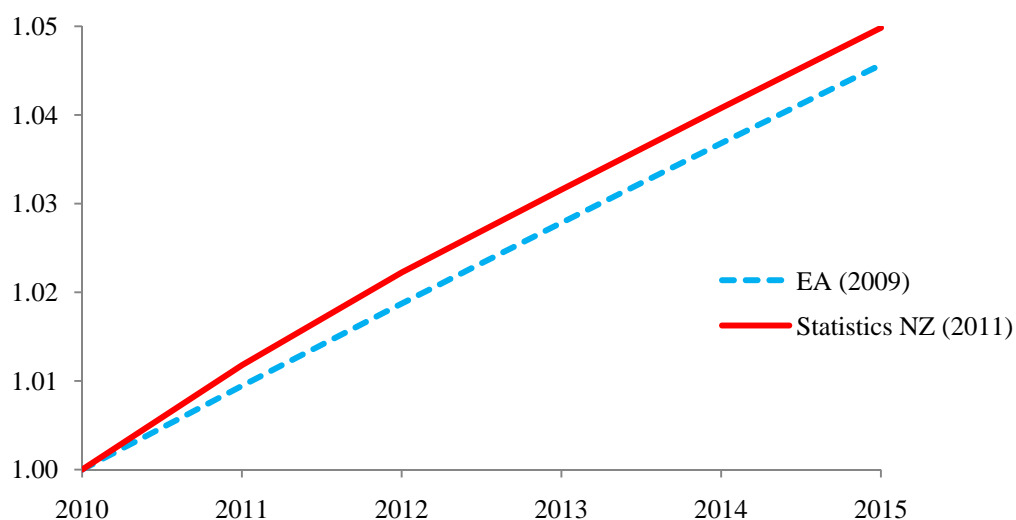
Source: NZIER June 2011; Electricity Authority 2009 Electricity Demand Forecasts

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<sup>8</sup> Now the Electricity Authority (EA).

<sup>9</sup> Summarised in the report: 2009 Electricity Demand Forecasts, 16 December 2009

### Difference in Population Growth Projection



Source: NZIER June 2011; Electricity Authority 2009 Electricity Demand Forecasts

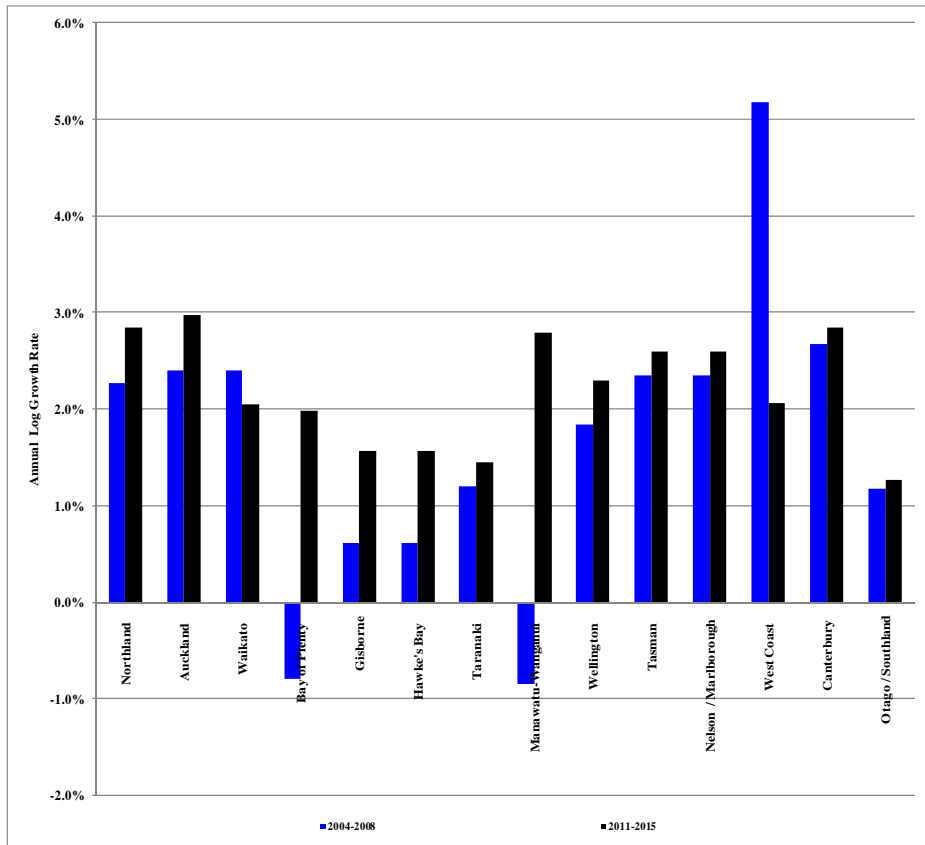
60. In deriving the EA's throughput forecasts, GDP and population growth are used to derive residential demand, with GDP used to project commercial and industrial demand. Figure 12 on page 20 of the EA's report shows the energy demand projections by sector. The growth in energy demand is mainly attributed to the commercial and industrial sector as illustrated in the following table.

	Domestic Total Forecast Demand	Industrial/Commercial Total Forecast Demand	Heavy Industry Total Forecast Demand (Tiwai)	Forecast Total Line Losses	Embedded Generation Forecast Demand	Forecast Total NZ Energy Demand
<b>Growth Rates (pa) 2010 - 2015</b>	1.92%	3.23%	0.00%	2.73%	2.39%	2.39%
<b>Proportion of 2010 Demand</b>	33.60%	53.09%	13.77%	4.53%	(4.98%)	100.00%

Source: Electricity Authority 2009 Electricity Demand Forecasts, ENA analysis

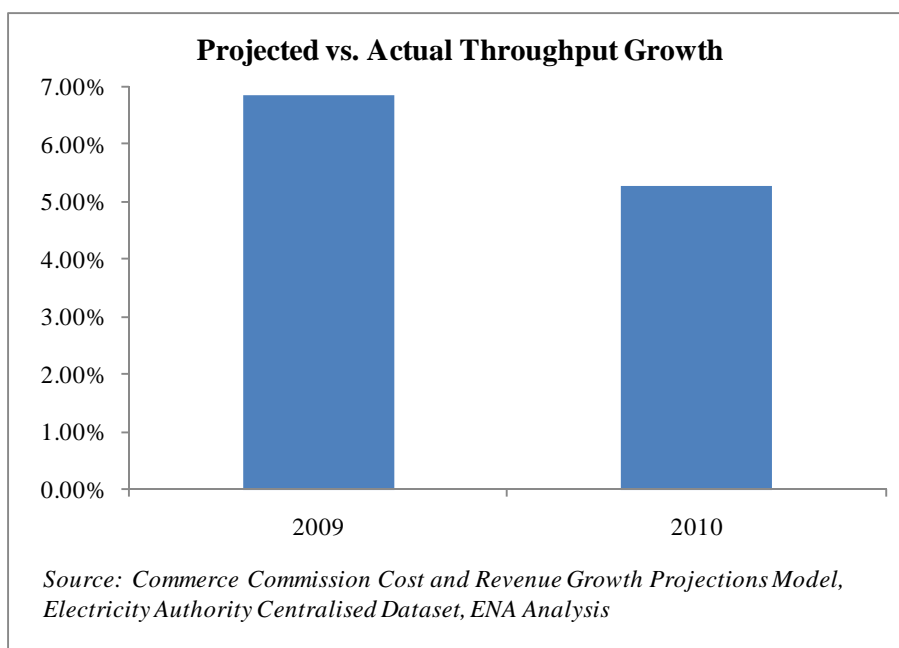
61. We also note that the comparison between historical throughput growth rates and forecast throughput growth rates by region, as set out in the Commission's Cost and Revenue Projections model, show significant divergences. These are illustrated in the Commission's chart, reproduced below. In all regions with the exception of Waikato and West Coast the projections exceed the historical

period. There appears to have been no consideration of these outcomes in determining the appropriateness or otherwise of assumed future growth rates.



Source: Commerce Commission Revised 2010-2015 Cost Revenue Growth Model

62. The higher GDP forecast assumed in the EA model is therefore contributing significantly to the real revenue assumptions in the Commission's model. This suggests the real revenue forecast is likely to be overstated given current economic conditions and the more up to date forecasts from NZIER. We note this is partly offset by the lower population projection assumptions in the EA model, however these forecasts are less significant as they are only applied to residential forecasts, and are also combined with other factors including GDP.
63. The EA's throughput projections can be compared to actual outcomes for the 2009 and 2010 periods (ending March). The following analysis supports our view that the EA's forecasts of throughput are too high. Forecast output is higher in both 2009 and 2010.



64. Accordingly, the ENA submits that the variable real revenue growth forecasts in the 2011 Draft Decision are unlikely to be achieved throughout the remainder of the DPP regulatory period given they are based on out of date economic growth assumptions underpinning the energy forecasts. This is supported by the most recent Energy Outlook issued by the MED<sup>10</sup> which projects a long term consumer energy demand growth rate of 0.9% per annum, compared to the EA’s forecast for all regions for 2010 – 2015 of 2.2% per annum.
65. The electricity market regulator and system operator require forecasts of electricity demand in order to prudently manage the electricity system. However their primary requirements are for peak demand rather than throughput forecasts. Accordingly national forecasts that have been developed with a focus on throughput are not readily available. Conversely the Commission has developed a model for the DPP starting price reset which relies on throughput forecasts which can be applied to each non-exempt EDB. Thus we recommend that the Commission, if it wishes to proceed with incorporating throughput forecasts in its SPA model, needs to acquire or compile forecasts that have been prepared with more up to date assumptions and for the purpose of forecasting throughput. An updated throughput forecast generated from the EA’s models would appear to be the most practical solution.
66. However, in the absence of updated EA forecast data we suggest the EA throughput information is not used, and variable revenue forecasts are derived

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<sup>10</sup> *New Zealand’s Energy Outlook 2010*, Ministry of Economic Development

from a combination of the GDP and population forecasts used for the capacity and fixed revenue values. These could be applied on the basis of residential and commercial/industrial consumption mix (with information to be provided by EDBs) or small, medium and large consumption mix (with information extracted from the MP3 Schedule of the IDRs). Population growth rates would be more relevant for residential or small consumers, and GDP growth rates for commercial/industrial or larger consumers. We acknowledge an alternative solution may be required for those which price on a GXP basis.

### ***Application of forecast growth data***

67. If the EA forecasts of throughput are to be used, this data series includes sector, regional and GXP output. The Commission's model uses the regional demand forecasts and allocates each non-exempt EDB to a region or regions. In some instances proxies are assumed where the Commission deemed it was not possible to directly allocate a network to a region. This has introduced unsatisfactory anomalies in the variable revenue forecast assumptions where the regions have been mismatched to some networks, and where the regional trend differs to that of the GXP subset relevant to each network.
68. As GXP forecasts are generated from the EA's models the ENA submits the GXP forecasts should be applied to each network, with appropriate consideration of embedded generation forecasts within each network region, rather than the regional forecasts which do not align sufficiently for all networks. This approach would remove an unnecessary source of forecast error.
69. In addition we note the application of the real revenue growth assumption to opex. For most EDBs the real revenue growth forecast is, by weight, driven by kWh growth. As we have noted to the Commission in the past, EDBs do not sell kWh, but capacity, and there is no theoretical link (or empirically based link that we are aware of) between volume changes and changes in opex. As has been noted to the Commission previously, key components of opex are driven by cycles in maintenance activity and most strongly driven by growth in the coverage of the network and asset age.

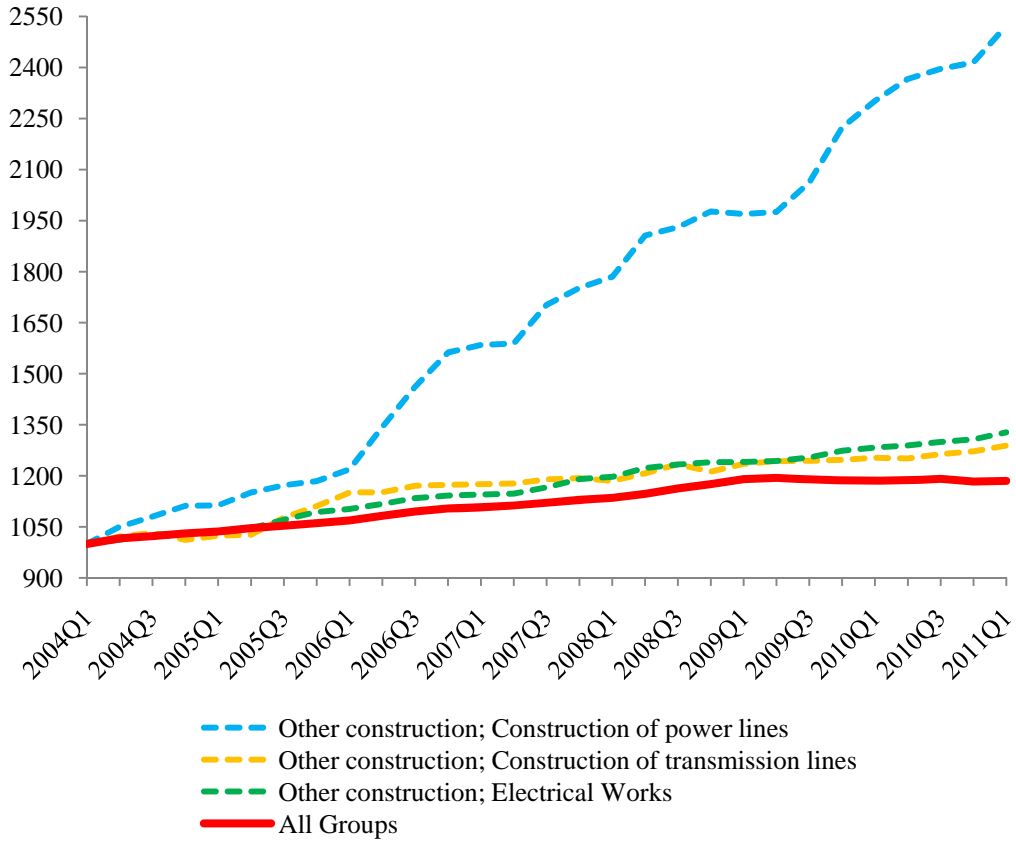
### ***Price Indices***

70. The forecast input price inflation required for the model uses three economy wide indices sourced from NZIER: LCI, PPI and CGPI. However as illustrated below, the industry specific indices have at least matched and in some cases substantially exceeded their all industries equivalents.<sup>11</sup>

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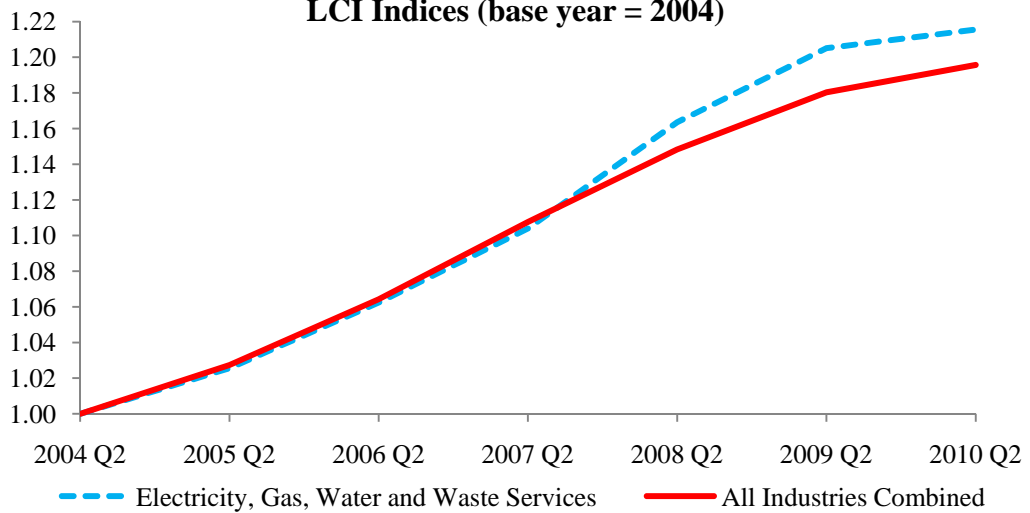
<sup>11</sup> These industry specific indices were considered the most relevant indices for EDBs in Meyrick Associates, Indexing the Regulatory Asset Base of Electricity Lines Businesses, 8 July 2005

**CGPI Indices (base year = 2004)**

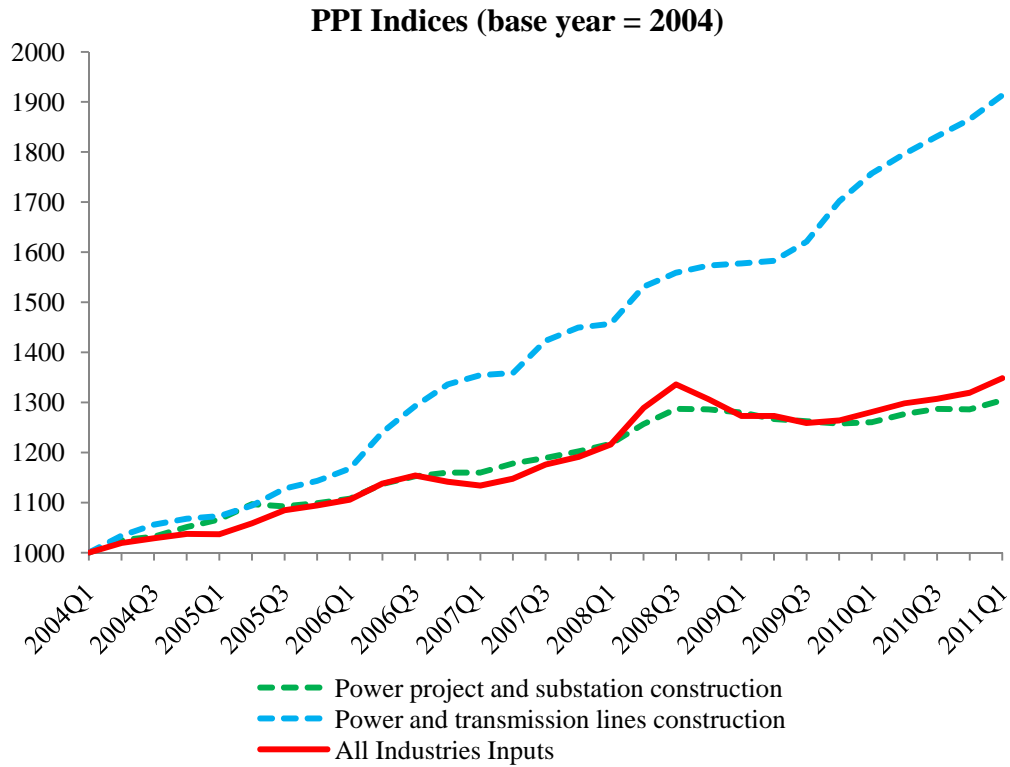


Source: Statistics New Zealand, ENA analysis

**LCI Indices (base year = 2004)**



Source: Statistics NZ, ENA analysis



Source: Statistics NZ, ENA analysis

71. This trend is consistent with the updated ODV Valuation Handbook generated by SKM and PwC from industry data last year. The Handbook included updated replacement costs for distribution network components, derived from industry wide data which was prepared consistent with ODV principles, ie: efficient scale of construction etc. A summary of the movement in replacement costs (from 2004 – 2010) by asset category is presented in the table below.

Asset Class	2010 - 2004 Handbook (% change)
33kV Lines	40%
33kV Cables	61%
33kV Switchgear	50%
22/11kV Lines	91%
22/11 kV Cables	86%
LV Lines	184%
LV Cables	121%
Distribution Switchgear	78%
Distribution Transformers	18%

Source: PwC SKM 2010 ODV Handbook

72. Accordingly we conclude that the price indices used in the Commission’s forecast model, are likely to under estimate the opex and capex input price inflation for EDBs, assuming the relative trend over the 2004-2010 period persists throughout the current regulatory period. Given the ongoing pressures on the infrastructure sector, brought about by such factors as Government driven infrastructure spend on roads and fibre optic networks, Transpower’s extensive build programme, Christchurch’s earthquake recovery, ongoing competition from offshore for skilled electrical workers, and relative weakness in consumption-linked sectors, we see no reason that there will not continue to be higher rates of price escalation faced by EDBs relative to the rest of the economy.
73. The Commission has developed a model which requires forecasts of input price inflation for EDBs. As for the variable revenue growth assumption, it is reasonable to expect that the Commission will have access to the information necessary to implement this model, or in the absence of readily available information, have commissioned appropriate advice to develop it. Accordingly, and in the absence of valid input price forecasts, the ENA submits that the Commission acquires forecasts of the relevant capital, labour and materials price indices for EDBs. This is consistent with the findings of Meyrick in 2005 which suggested an EDB capital goods price index would be a useful solution to the RAB indexation issue.<sup>12</sup>

#### ***Impact of forecasting assumptions on the DPP price path***

74. As outlined above, we believe the real revenue growth forecast is likely to be overstated. This is primarily due to the higher GDP forecasts assumed in the EA’s energy forecast than the more recent forecasts available from NZIER, and the continuing fragility of the global economy which has escalated in recent weeks. In addition, we believe the price escalators assumed for the forecast will understate the input costs faced by EDBs as evidenced over the last regulatory period.
75. These two factors combine in the Commission’s model to overstate the expected future profits of each non-exempt EDB. This translates to lower allowable revenues in 2012/13 than those required to provide a normal return using the proposed methodology should the draft decision be implemented.

#### ***Requirements of the proposed method***

76. The proposed SPA method is heavily dependent on the forecast assumptions. It is reasonable therefore to expect that the forecasts used will be fit for purpose and that sufficient analysis has been undertaken to generate appropriate

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<sup>12</sup> Meyrick, 2005 page 7 “This means the overall CGPI is unlikely to be a suitable index as it does not reflect the composition of lines business assets sufficiently well” and “We thus require CGPIs that are linked to the major assets of lines, cables and transformers as closely as possible.”

assumptions for use within the proposed model. The ENA submits that the proposed forecasts are deficient because they are not consistently based on up to date information and they do not reflect available trend data relevant to the electricity distribution sector.

### **Differential X factors**

77. The Draft Decision includes differential X factors for EDBs with positive starting price adjustments which exceed certain thresholds. These are calculated on a NPV neutral basis, solving for the same allowed revenue over the three year DPP period in present value terms.
78. The ENA submits that all non-exempt EDBs should have the opportunity to propose alternative X factors, calculated in a similar manner (ie: which are NPV neutral). This will enable businesses to take into consideration their customer base, pricing methodologies and expenditure plans when assessing their pricing options over the DPP.

### **Recommendation**

79. Given the proposed model and its sensitivity to growth forecasts, the ENA recommends the following:
  - That the Commission acquire up to date EA throughput forecasts to be based on GDP and population projections consistent with those used elsewhere in the model, or as an alternative use GDP and population rates of growth to project variable revenue growth, acknowledging an alternative approach may be required for those that price on a GXP basis;
  - That GXP rather than regional forecasts are used for each network;
  - That sector price index forecasts are acquired and used in the model; and
  - That EDBs are able to propose alternative X factors, on a NPV neutral basis.

## **4. Proposed price path compliance formula**

80. Appendix E of the 2011 DPP Draft Decision sets out a proposed compliance formula which gives effect to the allowable revenue and, where relevant, alternative rate of change, consistent with the weighted average price cap component of the DPP.
81. The 2011 DPP Draft Decision includes a proposed price path reset to maximum allowable prices in 2012/13 such that each EDB is projected to earn a normal rate of return between 2012/13 and 2014/15.<sup>13</sup> The proposed reset is therefore

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<sup>13</sup> 2011 DPP Draft Decision, paragraph 1.36

forward looking and if implemented will involve a step change to the price path (represented by Allowable Notional Revenue or 'R') at the third assessment date 31 March 2013.

82. The DPP prior to that date is unchanged, as are the compliance requirements for non-exempt EDBs for the first and second assessment periods (ie: up to 31 March 2012).
83. Thus it is proposed to modify  $R_{2013}$  to reflect the proposed allowed revenue for each EDB for the 2012/13 assessment period. The allowed revenue for 2012/13, along with the CPI and X factors set out in the draft decision, have been derived to meet the Commission's objective for each EDB to earn a normal rate of return over the remainder of the DPP.
84. The proposed formula for  $R_{2013}$  is as follows:

$$R_{2013} = ((AR_{2013} + (K_{2013} + V_{2013}))/\Delta D - (K_{2013} + V_{2013}))$$

Where:

AR is the allowable revenue for 2012/13 from the Commission's model

$\Delta D$  is determined as the compounded real revenue growth projections applied in the Commission's model for 1 April 2011 to 31 March 2012 and 1 April 2012 to 31 March 2013.

K is the sum of all pass through costs

V is the sum of all recoverable costs

85. Under the current DPP,  $R_{2013}$  is determined as follows:

$$R_{2013} = ((\sum P_{2012} Q_{2011} - K_{2011}) + (R_{2011} - NR_{2011})) \times ((1 + \Delta CPI) \times (1 - X))$$

Where:

P refers to prices charged for electricity line services

Q refers to quantities corresponding to each price

K is the sum of all pass through costs<sup>14</sup>

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<sup>14</sup> The equivalent terms are K and V in the new formula, reflecting the modifications arising from the IMs.

86. The draft decision is forward looking and is not intended to change the existing DPP prior to the third assessment period (ie: prior to 1 April 2012). The draft decision is to implement a change in allowable revenue in the third assessment period which arises from the Commission's projections of revenue and costs from 1 April 2012 onwards.
87. The proposed formula for  $R_{2013}$  however is not consistent with the draft decision because:
- It modifies the performance for all non-exempt EDBs for the 2012 assessment period by ignoring the  $(R_{t-1} - NR_{t-1})$  revenue differential adjustment term which provides any prior period difference between the prices permitted under the price path, and the actual prices charged to be offset in the next assessment period.
  - It includes a  $\Delta D$  term which incorporates assumptions from the Commission's model which apply to assessment periods within the existing DPP (ie: prior to the reset) which differ to the actual performance of each EDB within the existing DPP. This introduces revenue risk within the reset formula that relates to performance prior to the period from when the reset DPP is to apply (April 2012) and thus is inconsistent with the forward looking draft decision. It is expected there will be some revenue risk over a DPP period, however the ENA submits such risks should not relate to the period prior to when the reset is to apply.
88. Accordingly it is submitted that the proposed compliance formula set out in Appendix E5 is inconsistent with the draft decision.

## Revenue adjustment term

89. In order to ensure the price path is set consistent with the expectations of non-exempt EDBs when prices were set for the second assessment period (ie: at 1 April 2011) the revenue adjustment term should be retained for  $R_{2013}$ . It is reasonable for EDBs to have allowed for head room in their price path compliance given the uncertainty and potential significance of the penalties that may arise following a price path breach. This prudence has been facilitated by the revenue adjustment term which provides for an ex-post wash up in the following assessment period. The same mechanism allows for unintentional over recovery of pass through costs to be passed back to consumers in the following period. Thus the adjustment term is an important component of the price path which should not be excluded in the SPA reset.
90. This missing term can be included as a simple  $+ (R_{t-1} - NR_{t-1})$  as it is in the existing DPP price path, and as it is proposed to be for the fourth and fifth assessment periods.

## Real revenue growth adjustment

91. The proposed compounded real revenue growth adjustment term is intended to adjust the allowable revenue for the 2012/13 year to allowable notional revenue at the 31 March 2013 assessment date. It is proposed that quantities which are forecast in the Commission's model are to be used to derive allowable notional revenue. However this is not consistent with a forward looking reset as it incorporates assumptions in the Commission's model for periods prior to the reset into the reset adjustment. It is likely that an EDB's quantities for each price item in the period prior to the April 2012 will differ to those forecast by the Commission. If this is the case, and if the proposed compliance formula is adopted, the Commission's over or under estimation of real revenue growth for the 2012 and 2013 assessment periods will be reflected in  $R_{2013}$  via the proposed real revenue growth term.
92. The ENA submits this is inconsistent with the draft decision which is to adjust the DPP as at April 2012 on the basis of projected revenues and costs for the April 2012 – March 2015 period.
93. Using an example, a business with 2013 allowable revenue of \$100, and  $\Delta D$  of 103% will (assuming no K and V impact) be assigned an  $R_{2013}$  of \$97.09 under the draft decision. If that business is only able to achieve an actual  $\Delta D$  of 102%, its actual revenue in 2013 will be \$99.03, less than the target allowable revenue required to earn normal returns consistent with the draft decision. Thus overestimation of real revenue growth in the first part of the DPP detrimentally impacts on the allowable revenue at 2012/13. This compounds the detrimental impact of the overestimation of real revenue growth in the last three years of the DPP. This highlights the need to include prudent forecasts of real revenue growth in the model, but also to include an error correction mechanism.
94. The use of the  $\Delta D$  term derived from the model is partly in response to the requirement to estimate real revenue growth in order to set prices at the beginning of the 2013 assessment period, prior to actual quantities being known. Given the uncertainty, and possible detriment as illustrated above, an adjustment term should be incorporated into the DPP to allow businesses to fully recover the target revenue in following periods similar to the R-NR revenue adjustment term currently included in the price path.
95. This adjustment could be accommodated in the final year of the DPP, once the actual 2013 revenue is known. The adjustment would include:
  - expected  $AR_{2013}$  – actual  $AR_{2013}$  (to adjust for the under/over recovery in the 2013 assessment period);
  - expected  $AR_{2013}$  – actual  $AR_{2013}$  \* CPI - X (to adjust for the impact of the roll forward of the 2013 under/over recovery to the 2014 assessment period);and

- expected  $AR_{2013} - \text{actual } AR_{2013} * CPI - X * CPI - X$  (to adjust for the impact of the roll forward of the under/over recovery to the 2015 assessment period).

### **Recommendation**

96. That the proposed compliance term for  $R_{2013}$  incorporate the  $(R_{2012} - NR_{2012})$  term from the existing DPP price path.
97. That the  $R_{2015}$  incorporate an adjustment factor to address divergence between assumed and actual  $\Delta D$  term in the proposed compliance formula. This is required to ensure the  $AR_{2013}$  is able to be achieved by all EDBs.

## **5. Other proposed amendments to the DPP**

98. The 2011 SPA Paper also proposes a number of other amendments to be made to the DPP. Section 52Q provides for amendments to a section 52P determination and specifies in subsection (1) that:
  - material amendments may be made following consultation; and
  - non material amendments may be made without consultation.
99. In addition section 54K(3) includes provisions which specifically relate to the 2010-2015 DPP. Where 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.
100. The proposed SPAs are to be made pursuant to section 54K(3), ie: as a direct result of the IMs. Chapter 1 of the 2011 DPP Draft Decision sets out the Commission's reasons for this change, and concludes the change meets the 54K(3) materiality criterion. In addition, it is also proposed that the CPI component of the price path be amended under the section 54K(3) provisions as the IM definition of CPI is deemed by the Commission to be materially different to that currently included in the DPP.
101. A number of other amendments are also proposed, some of which are IM related and others are not. It is not clear from the 2011 DPP Draft Decisions whether the Commission has proposed these additional changes in response to the 54K(3) or 52Q provisions.

### **Changes to be made to Clause 4.1**

102. It is proposed that the following definitions are to be changed to be consistent with the IMs:

- Price
  - Posted discount
  - GST
  - Electricity Distribution Service
  - Pass-through Costs
  - Recoverable Costs
  - Avoided Transmission Charges
  - Electricity Commission Levy
  - Commerce Act Levy
  - Rates
  - Transmission Charges
  - Director
  - CPI.
103. We note that the proposed definition of avoided transmission charges, which is to be incorporated into the DPP price path via the recoverable cost definition included in 3.1.3(1) of the IMs is different to the current DPP definition, and it now excludes components of cost which were previously permitted. This has the effect of potentially excluding from recoverable costs, the recovery of costs from investments already made in accordance with the previous definition. The ENA submits this is unjustifiably retrospective and inconsistent with promoting investment certainty.
104. Accordingly, the avoided transmission charge component of recoverable costs under the reset DPP needs to include an additional category of avoided transmission costs which permits the recovery of any expense (including the cost of capital) from any investment or activity which substitutes for the use of the transmission system that existed on or before 31 March 2012. This should apply until the end of the current DPP (ie: until 2015) which would be consistent with the expectations of EDBs when prices were set.

## **Other processes specified in the DPP Determination**

### ***CPP Application Window***

105. It is proposed that the DPP determination include the deadlines for making a CPP application throughout the DPP period. The draft decision proposes that submissions of a CPP proposal may only be made:

- In the last week of January 2012 and 2013; and
  - In the event that fewer than four applications are received in each January, in the first week of March in 2012 and 2013; and
  - At any time, other than 12 months prior to the end of a DPP period, in response to a catastrophic event.
106. The ENA has previously submitted that the proposed ‘application window’ approach is a pragmatic solution to the need to potentially prioritise applications for EDBs. The ENA has also previously submitted the desirability for additional applications to be considered where fewer than four are received within the window. This is now accommodated with the proposed additional window in the first week in March. We note that this allows only five weeks for additional applications to be prepared and submitted, which is insufficient for the pre verification process which must be completed prior to submission and suggest that as a result this extended window is not a practical option.
107. The availability of a CPP is an important component of the Commission’s proposed method as it is viewed as a means of correcting inaccuracies in the DPP. However the proposed 2012 reset will apply for three years, which is less than the standard five year regulatory period, which will apply in the future. Thus it is proposed that application windows be limited to just two years (2012 and 2013) for the current DPP.
108. In reality the ENA submits that it is unlikely that any EDB will be able to make a CPP proposal within the proposed 2012 application windows. The DPP will not be determined until 20 October 2011. It is not possible for an EDB to determine whether a CPP proposal is required until the final decision is known. Following this an EDB must:
- Prepare its CPP proposal setting out the impact on prices and quality standards;
  - Undertake consultation with consumers which must allow for a consultation period of at least 40 working days;
  - Consider consumers’ views and modify its CPP proposal accordingly; and
  - Complete the required pre verification process.
109. Thus the earliest a CPP application is likely to be received is in the 2013 application period(s), for a determination to apply from 1 April 2014, the final year of the DPP. We submit this is insufficient remedy for the proposed DPP reset. We would expect any remedy available via a CPP would apply for at least the majority of the regulatory period.
110. Accordingly the ENA submits that the Commission should consider any proposal received at any time other than the January window, with the objective

of making a CPP determination as early as practicable, similar to the provisions for CPP proposals received in response to a catastrophic event. In addition, we submit that CPP proposals in response to a catastrophic event should be considered in the final year of the DPP period. We do not believe that the DPP reset process is intended to address the circumstances included in the IM definition of a catastrophic event, and therefore we do not anticipate that a DPP reset will adequately address the consequences of such an event. Accordingly it is unreasonable to defer consideration of such events and the appropriate remedies during a reset period.

111. We also note that the terms ‘last week in January’ and ‘first week in March’ in the draft DPP determination are insufficiently precise. We suggest they are replaced by the terms ‘no later than 5pm on 31 January or the next business day where 31 January does not fall on a business day’ and ‘no later than 7 March or the next business day where 7 March does not fall on a business day’.

### ***Transactions***

112. The proposed changes to the DPP determination where non exempt EDBs transact within a DPP period are partly covered by IM clause 3.2.1. However this clause specifically refers to amalgamations. The 2011 DPP Draft Decision also addresses significant transactions which are not amalgamations. It proposes to do this as follows:
- Where the transaction is a takeover, merger or 100% asset purchase, it is to be treated the same as an amalgamation as per the IM;
  - Where any other transaction is significant (refer below) each non-exempt EDB involved must:
    - Assess compliance with its DPP for the Assessment Period;
    - Notify the Commission (within 30 days) of the nature and effect of the transaction; and
    - The nature of compliance in future periods is to be determined in conjunction with the Commission.
113. Other significant transactions are defined as including:
- Disposal or acquisition of a significant portion of assets;
  - Affects a significant portion of liabilities or obligations of the EDB; or
  - Otherwise significantly changes the size of the non-exempt EDBs business or liabilities.
114. In this respect “significant” is defined as the proportion which the Commission considers to have a material impact on the calculation of the price path or the quality standards. We find these proposed clauses cumbersome and suggest that

Clauses 11.4 and 11.5 can be improved by better addressing the intent of 11.5 which is to identify non amalgamation transaction events which may have a material effect on the calculation of the price path or quality standards. We believe the proposed Clause 11.3 is too broad (ie: particularly the unqualified reference in 11.3(b) to ‘liabilities or obligations’).

115. These proposed requirements are also impractical, because they create circularity in the process. The proposed Clause 11.5 definition of ‘significant’ includes the following requirement ‘which the Commission considers may have a material effect’. The Commission’s view will not be known by the non-exempt EDB which is required to comply with this clause at the time the compliance statement is prepared. The Commission will not be able to form its view until the non-exempt EDB has supplied the information relevant to the clause.
116. Accordingly the ENA submits that in the event of a non amalgamation transaction, EDBs should submit self assessments in the year of the transaction against the existing DPP, and in addition notify the Commission of the transaction where the following criteria are met:
- The non-exempt EDB’s value of assets associated with the provision of electricity distribution services increases or decreases by more than 10% within an assessment period, as a result of a transaction; or
  - The non-exempt EDB’s notional revenue associated with the provision of electricity distribution services increases or decreases by more than 10% within an assessment period, as a result of a transaction.
117. In this respect we suggest the term ‘transaction’ could be defined as a purchase, merger, takeover, disposal or other similar transaction (as per the existing DPP) in order to distinguish changes in asset values and revenues arising from a transaction from those which may occur in normal business circumstances.
118. We also note there are drafting errors in clauses 11.3 and 11.4, including an incorrect reference to 11.2.

### ***Approval of recoverable costs***

119. It is proposed that certain recoverable costs require approval from the Commission to be included in the price path. These include, in accordance with the IM clause 3.1.3(1)(e), avoided Transpower charges arising from the purchase of Transpower assets. In previous consultations the Commission suggested and the ENA agreed that this approval process could be addressed in the annual compliance statement whereby the relevant EDB provided sufficient information, (to be certified by Directors and independently audited) to justify the recoverable cost. The draft DPP now includes additional information requirements in this respect in Clause 12.1(b)(iv), that the Compliance Statement includes proof of the transaction, the amount of the avoided

Transpower charge and where relevant proof of the new investment contract charge (which may be provided confidentially).

120. We find these proposed clauses somewhat cumbersome and in the associated clause 12.2 (which specifies how the charge is to be determined) is inappropriately included in Clause 12 which sets out the information to be included in the Compliance Statement. This definition would be more appropriately addressed in Clauses 4 and 9 which set out the interpretation and price path components respectively. It is confusing for users to seek out definitions relevant to the price path from Clause 12. These need to be collated together with the remainder of the price path in Clause 9 (which includes interpretation references to Clause 4).
121. We also note that the proposed drafting for the information required by the Commission uses the term 'proof' which is inconsistent with the terminology used throughout the rest of the DPP.
122. Accordingly we propose that Clause 12 (iv) is modified as follows:
  - (b) sufficient information to support the statement required by paragraph (a) including:
    - (iv) information relating to any amounts specified as Recoverable Costs consistent with clause 3.1.3(1)(e) including:
      - (a) The amounts of each charge included in the 3.1.3(1)(e) Recoverable Costs with reference to the types of charges specified in 3.1.3(1)(b) and 3.1.3(1)(c); and
      - (b) The derivation of any such charges derived with reference to 3.1.3(1)(b); and
      - (c) Contractual evidence of the asset purchase relevant to 3.1.3(1)(e), which may be provided to the Commission confidentially.
    - (v) Contractual evidence of any new investment agreement relevant to the 3.1.3(c) Recoverable Costs, which may be provided to the Commission confidentially.
123. In addition the proposed Clause 12.2 which specifies how the avoided transmission charges are to be calculated should be moved to [a new] Clause 9.10 below the existing 9.9 which includes specific provisions for Commerce Act Levies. This would ensure all of the explanatory requirements for determining the amount of the pass through and recoverable costs are collated together within Clause 9 which sets out how the price path is calculated.

## **Recommendation**

124. That the proposed DPP determination include avoided transmission recoverable costs for existing investments or activities which substitute for the transmission system, consistent with the current DPP;
125. That the Commission should consider any CPP proposal received at any time other than the January window, with the objective of making a CPP determination as early as practicable, and that CPP proposals in response to a catastrophic event should be able to be considered in the final year of the DPP period
126. That in the event of a non amalgamation transaction, EDBs submit self assessments in the year of the transaction against the existing DPP, and in addition notify the Commission of the transaction where the following criteria are met:
  - The non-exempt EDB's value of assets associated with the provision of electricity distribution services increases or decreases by more than 10% within an assessment period, as a result of a transaction; or
  - The non-exempt EDB's notional revenue associated with the provision of electricity distribution services increases or decreases by more than 10% within an assessment period, as a result of a transaction.
127. Amendments (as suggested above) be included to clarify the processes, compliance and reporting requirements for approval for recoverable costs.