
Submission to the Commerce Commission

on

2010 – 15 Default Price-Quality Path
for Electricity Distribution Businesses
- Draft Decisions Paper

Draft for Discussion
[24] August 2011

Made on behalf of 19 Electricity
Distribution Businesses



Submission on 2010 -15 Default Price Quality Path Reset - Draft Decisions Paper

This paper forms our submission on the Commerce Commission's (Commission's) 2010-15 Default Price-Quality Path for Electricity Distribution Businesses, Draft Decisions Paper (Draft Decisions), 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
- Model development
- Modelling approach
- Projecting profitability
- Forecasting real revenue
- Input price indices
- Alternative rates of change
- Proposed compliance formula
- Other proposed changes to the DPP.

Regulatory Framework

1. In our submission of 16 May 2011 prepared in response to the 2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments Update Paper (the Update Paper) issued in April 2011 we submitted in some detail on the regulatory framework and relationship between the Default Price-Quality

Path (DPP) and Customised Price-Quality Path (CPP) options for non-exempt EDBs. In essence we submitted that the DPP, whilst a lower cost regulatory mechanism than the full building blocks price path determined under a CPP, is expected to apply to most non-exempt EDBs most of the time. Thus a DPP is expected to reasonably accommodate business as usual circumstances.

2. Accordingly we are concerned that the proposed approach to setting the DPP appears to rely on the CPP option as an error correction mechanism. We do not believe this is consistent with the low cost intent of the DPP. In our view applying for a CPP because the DPP is not fit for purpose is not consistent with low cost regulation. Although we have not repeated our earlier submission on this topic in full, our view remains unchanged. We believe the Commission has an obligation to implement a DPP which is based on a robust model, populated with data and assumptions which are fit for purpose for all non-exempt EDBs.
3. We acknowledge that the Commission has improved its method in order to better reflect individual EDB circumstances, particularly the movement away from industry wide growth rates to regional growth rates for forecasting purposes. In addition the 2009/10 information received from each EDB in response to the March 2011 information request has now been included in the model which has improved the relevance of the current profitability estimates for each EDB.
4. We retain the view however that the proposed approach requires further improvement to avoid the likely outcome of non-exempt EDBs having to consider applying for a CPP in order to correct for errors in the DPP. Should the Commission persist with its proposed approach for 1 April 2012 and future resets we can envisage some EDBs entering a cycle of continuous CPPs because the DPP does not adequately reflect their business as usual circumstances. Clearly this is contrary to the intention of price-quality regulation for EDBs. We believe there are improvements which can be made to the DPP in the short time available which will reduce the probability of such an outcome and deliver a lower cost regulatory solution than the current Draft Decision.
5. In addition in respect of the 2012/13 price path reset we believe the CPP is an alternative which will provide little value given the timing proposed for CPP applications. It will be difficult for EDBs to meet the 2012 application window. If a decision to reset the DPP is issued on the 20th of October 2011, EDBs will have insufficient time to prepare a draft CPP proposal, undertake the consumer consultation process as set out in the CPP Input Methodology (IM), modify the proposal where necessary to reflect consumers' views and complete the pre-submission verification process by the end of January 2012. We note the CPP IM specifies a minimum of 40 working days for the consumer consultation period. An EDB will have to have completed its final draft CPP proposal prior to initiating this consultation. The possibility of an extended deadline to the first week in March is also of little assistance.
6. If EDBs are unable to make a CPP proposal in 2012, there is little remedy available to them within the current DPP. Any proposals made in 2013 will, at the earliest, result in a CPP from 1 April 2014 – the final year of the current DPP. Thus the potential relief from the proposed reset DPP price path is likely to be limited to the final year of the DPP. This endorses our submission that the Commission should apply all possible endeavours to set the best DPP possible for all non-exempt EDBs at this proposed reset.

Model Development

7. In our 16 May 2011 submission on the Update Paper we expressed our concern at the new approach to the price path reset proposed at that time. The Update Paper proposed a model which was different to that which had been consulted previously, as early as July 2009, and further endorsed in August 2010. We also expressed our disappointment that the Commission had ignored the additional work which the industry invested into the previous "WACC band" model and the relatively late introduction of the Commission's "new" model.
8. Despite these views, the model has again changed, just three months out from the decision. We acknowledge input data has changed, and this was expected, however the basic mechanics of the model have been altered. The consequence of these iterations is that insufficient time and resources have been dedicated to developing or acquiring the appropriate inputs to populate the model. We believe that good regulatory practice requires robust methods *and* fit for purpose information necessary to apply those

methods. In this respect we believe the current consultation process has been somewhat compromised because:

- The method has changed considerably during the consultation process and has been subject to significant change just three months out from the decision deadline without adequate consultation; and
 - The information currently used to populate the models is not suitable for its intended purpose.
9. We acknowledge the Electricity Networks Association's (ENA) submission that setting starting prices for DPP resets should be an Input Methodology (IM). We support this view because we believe that it is consistent with the regulatory certainty requirements of Part 4. The modifications to the proposed approaches over the past two years have illustrated how much discretion the Commission has available to it in this task. Each model has been put forward as a suitable approach to setting starting prices for the DPP and yet each model delivers different outcomes for consumers and suppliers (irrespective of the input data). Both the Update Paper and the Draft Decisions Paper indicate that the CPP alternative should be a reasonable option for non-exempt EDBs. However, although the CPP IM sets out some of the parameters for calculating the CPP price path, the matters of judgement the Commission has demonstrated during the DPP consultation process suggest a CPP outcome is far from certain for an EDB should the Commission continue to modify its approach.
10. In the remainder of this submission we set out the minimum improvements we believe are necessary to the proposed method in the context of a deadline which is now just two months away. They should not be taken as an endorsement of this approach for future resets where we would hope there is a clearly defined method available well before the reset and sufficient investment in developing or obtaining the information required by that method.

Modelling Approach

11. The proposed starting price adjustment (SPA) method as set out in the Draft Decisions is to reset maximum allowable prices in 2012/13 under the price path such that each EDB is projected to earn a normal return between 2012/13 and 2014/15. No changes are proposed for the quality standards or the industry wide X factor, although the CPI rate of change is to be altered to be consistent with the IMs. Differential X factors are proposed for those EDBs which have significant upwards SPAs in order to mitigate price shocks to consumers in 2012/13. No differential X factors are proposed for those with downwards SPAs.
12. In order to determine the 'normal return' over the remaining DPP period the model projects revenues and costs from a 2009/10 base year for each non-exempt EDB using a number of forecasting assumptions (for revenue, opex and capex). It approximates a regulatory profit measure by rolling forward the Regulatory Asset Base (RAB) and regulatory tax variables (such as deferred tax balances and tax asset values) in a manner which is broadly consistent with the relevant IMs for Information Disclosure (ID) and CPP purposes. Allowable revenue is determined by applying the DPP cost of capital (as specified per the IM) to the regulatory investment value (RIV) and including allowances for regulatory depreciation, regulatory tax, opex, revaluations and term credit spread differentials.
13. Since April the model has been updated with EDB specific information for 2009/10 and new forecasting assumptions for CPI, revenue, opex and capex. We believe it is reasonable to improve the information and data sources following the first consultation round on the proposed forecast model approach. The July 2011 model though includes a new approach to discounting future costs and revenues which was not included in the April model, and to the best of our knowledge has not been used by the Commission previously for EDBs.
14. We believe the proposed method incorrectly seeks to combine profit and cash flow measurement principles into the same calculation. It does this by assuming that some cash flows (namely opex and revenue) occur midway through a year, but other cash flows (tax) occur at the end of the year, and other non cash regulatory profit measures (depreciation, revaluation and return on assets) occur at year end.
15. The SPA model is a profit model, not a cash flow model, and does not include in it all of the cash flows, such as working capital, which must be included in cash flow models such as those used for valuation purposes.

It also does not adequately consider the tax payment profile of each business. In addition, the proposed profit measurement (which includes a mix of year end and mid year measures) differs to the regulatory profit measures used historically by the Commission for ID purposes. We note that the recent consultation workshop on proposed refinements to ID Requirements did not propose a similar change to the return on investment (ROI) measure. This is directly comparable to the regulatory profit in the SPA model.

16. The RAB IM has been specified to generate outputs which are consistent with a year end profit measure. Accordingly we submit that the SPA model must be based on a year end profit measure and the discounting of all profit items should be consistent with this method.

Projecting Profitability

Base Year Data

17. The SPA model is heavily reliant on the assumptions used to project revenues and costs from the 2009/10 base year for the next five years, ending 2014/15. As stated in our 16 May 2011 submission we agree that for the purpose of the 2011-2015 DPP, the 2009/10 year is relevant to the estimation of current profitability. In addition a number of the IMs set a starting position at 1 April 2009. Thus the restatement of profit to incorporate those IMs is appropriate.
18. We also previously noted that the proposed 2010-15 DPP reset involves setting starting prices 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 suggested 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. However we submit that the full set of information collected for 2009/10 is not required to improve the forecasts for 2010/11. In our view the 2010/11 actual revenue, opex and capex for each non-exempt EDB could be included to improve the forecasts of profitability. This should be available from the 2011 disclosures next week, and we anticipate any adjustments to these values in order to reflect the IMs could be accommodated by applying the same method (such as cost allocation) as applied in 2010. This could be an optional adjustment, where EDBs who are able to demonstrate that the 2010/11 forecasts are unacceptably inaccurate are able to provide the Commission with 2010/11 revenue, opex and capex data (consistent with the IMs) for inclusion in the model. In our view it is unreasonable to prohibit 2010/11 outcomes from the model where they are available in a format which is consistent with the model's requirements.

2011 AMPs

19. In addition we submit that the opex and capex forecasts over the remainder of the DPP period should be improved by using the most recent capex and maintenance forecasts from the 2011 AMPs for each non-exempt EDB. It is not clear why the 2010 AMPs have been favoured over the 2011 AMPs. Given the Commission is to apply 2011 forecasts of capex and opex price inflation to the underlying real capex and opex for each EDB, it follows 2011 AMPs should be used. This is consistent with using the most up to date information available at the time the decision is made. 2010 capex forecasts have now been superseded by 2011 forecasts and should be used.

Projecting Opex

20. In addition, we believe the forecasts of real opex growth should not be based on real revenue growth rates. There is no relationship between revenue growth (which for most EDBs is dominated by throughput growth) and opex. A large proportion of opex is maintenance and EDBs publish maintenance forecasts along with their capex forecasts. Maintenance expenses typically contribute a significant proportion of opex costs, although the proportion varies between EDBs, and varies over time. There is an inherent trade-off in an EDB's business between capex and maintenance, which appropriately is addressed in each EDB's AMP. Thus annual maintenance costs will reflect the capex plan for each EDB, and vice versa. For example, the allocation of renewals expenditure between capital and maintenance reflects the application of the various accounting standards to projects which have similar drivers and outcomes. In addition, there will be capex and maintenance tradeoffs which are reflected in an AMP forecast each year. Accordingly it is

important to view the combined AMP expenditure forecasts (capex and maintenance) as an integrated forecast of asset related expenditure.

21. The proposed approach uses AMP data to derive capex forecasts for each EDB but ignores the corresponding maintenance forecasts in the AMPs. It would be more robust and consistent to incorporate the AMP forecasts for both capex and maintenance, and to separate maintenance from non maintenance expenditure for the purpose of forecasting real opex growth rates. This is possible as the opening year opex has been disclosed on this basis. Non maintenance opex can continue to be forecast using other real growth rates but the maintenance opex can and should be forecast using the same method as capex (i.e. by using the 2011 AMP forecasts). For non maintenance real opex growth rates we submit that population growth is the best proxy, as it is indicative of ICP growth. As non maintenance opex is made up of corporate overheads and system operations and planning, we believe the number of connection points is a more valid growth driver than either throughput or GDP. These costs are more reflective of the number of customers serviced rather than their size or demand on the network.

Forecasting Real Revenue

Revenue Weights

22. It is proposed that real revenue growth is forecast using three drivers: throughput growth for variable revenue; GDP growth for capacity revenue and population growth for fixed revenue. Revenue weights have been provided by each non-exempt EDB in accordance with the Commission's information request. It is proposed that revenue weights derived from 2011 revenue are used as this is the most recent information available. We support the use of the most recent information, but as noted above, this principle has not been applied to the AMP data. We believe it should be.
23. The 2011 revenue weights provided in accordance with the Commission's information request reflect lagged quantities. The Cost and Revenue growth model explains this as follows: "*The quantities relating to each pricing year relates to the quantities from the pricing year two years earlier. This means that for 2010 the quantities cover the period 1 April 2008 to 31 March 2009. For 2011 the quantities cover the period 1 April 2009 to 31 March 2010.*"
24. The lagging assumed in this specification is inconsistent with the DPP which assumes a two year lag from the end of each assessment period, but a one year lag from the beginning of the assessment period (ie: when prices are set). The DPP assessment for the year ending 31 March 2011 uses 2009, not 2010 quantities as specified in the Commission's information request. This is because 2010 quantities were not known when 2011 prices were set (ie: at 1 April 2010). If the Commission wishes to use lagged quantities, then we submit they should be consistent with the DPP. However given the revenue weights are assumed to remain constant over the forecast period, actual revenue weights for 2011 would be reasonable. The current approach is neither consistent with the DPP, nor actual revenue for 2011.

Growth Rates

25. The growth rates assigned to the three sources of revenue for each non-exempt EDB reflect regional growth rates derived from Electricity Authority (EA) throughput forecasts, NZIER GDP forecasts and Statistics New Zealand population forecasts. The proposed rates of growth for each non-exempt EDB are as follows:

Revenue Source	Variable Revenue	Capacity Revenue	Fixed Revenue
Driver	Throughput	GDP	Population
Alpine Energy	3.02%	3.19%	0.85%
Aurora Energy	1.89%	-1.06%	0.35%
Centralines	1.65%	0.08%	0.26%
Eastland Network	1.65%	0.08%	0.09%
Electricity Ashburton	3.02%	3.19%	0.85%
Electricity Invercargill	1.89%	-1.06%	0.35%
Horizon Energy	2.04%	0.85%	0.89%
Nelson Electricity	2.86%	1.63%	0.57%
Network Tasman	2.86%	1.63%	0.57%
OtagoNet	1.89%	-1.06%	0.35%
Powerco	2.06%	0.96%	0.49%
The Lines Company	2.06%	1.28%	0.77%
Top Energy	2.98%	1.03%	0.58%
Unison Networks	1.81%	0.41%	0.53%
Vector	2.99%	3.73%	1.56%
Wellington Electricity	2.36%	1.99%	0.70%
Average	2.31%	1.06%	0.61%

26. As illustrated above there are notable discrepancies in the three growth rates applied to each non-exempt EDB. In many instances the average throughput growth rates¹ significantly exceed the GDP and population growth rates applied to the same EDB (examples include Eastland Networks, Electricity Invercargill, Horizon Energy and Top Energy). This divergence illustrates that the input assumptions are inconsistent, and we therefore submit they generate outputs which are not sensible. In particular, on average, throughput growth rates exceed GDP growth rates (by at least 2 times) and population growth rates (by almost four times). This result suggests declining energy intensity (a measure of energy use and GDP) which we note is contrary to the MED's 2010 Energy Outlook which forecasts improving energy intensity - by 2.2% per annum to 2030. Long term consumer energy demand is projected to increase at just 0.9% per annum compared to 1.4% since 1990. The corresponding long term central economic growth forecast is 2.3% per annum.²
27. We also note the variances between historical annual throughput growth and the forecasts used in the Draft Decision. This data is included in the Commission's models, however does not appear to have been adequately considered. There are significant anomalies in the Bay of Plenty, Manawatu-Wanganui and West Coast regions which are not explained, and in all except two regions the forecasts exceed the historical growth rates actually achieved.

¹ Throughput growth rates are presented in this table as a five year average for each non-exempt EDB. The Commission's proposed approach is to include annual growth rates consistent with the EA forecasts.

² MED, New Zealand's Energy Outlook 2010, Reference Scenario and Sensitivity Analysis, pages 1-2

Throughput Growth Rates			
	Forecast (2011-2015)	Historical (2004-2008)	Variance
Northland region	2.85%	2.27%	0.58%
Auckland region	2.97%	2.40%	0.58%
Waikato region	2.05%	2.40%	-0.35%
Bay of Plenty region	1.99%	-0.80%	2.79%
Gisborne region	1.56%	0.61%	0.95%
Hawke's Bay region	1.56%	0.61%	0.95%
Taranaki region	1.44%	1.20%	0.25%
Manawatu-Wanganui region	2.79%	-0.85%	3.64%
Wellington region	2.30%	1.84%	0.46%
Tasman region	2.60%	2.35%	0.25%
Nelson/ Marlborough region	2.60%	2.35%	0.25%
West Coast region	2.07%	5.18%	-3.11%
Canterbury region	2.85%	2.67%	0.17%
Otago / Southland region	1.27%	1.18%	0.09%
Average	2.21%	1.67%	0.54%

28. We note that the EA's throughput forecasts are based on 2009 models and input assumptions. The EA's model assumes an underlying national GDP forecast of 3.5% per annum for 2010-2015. The more up to date national GDP forecast supplied by NZIER for the capacity revenue growth assumption is 2.0% per annum for the same period. We submit that the EA's throughput forecasts are not suitable for the variable revenue growth assumptions because they include underlying assumptions which are now outdated. As a result they generate results which are inconsistent with the MED's energy use expectations and the fixed and capacity revenue growth assumptions used elsewhere in the Commission's model.

Regional Allocation

29. Each non-exempt EDB has been assigned to a region for the purpose of determining growth rates for throughput, population and GDP. We believe the application of regional forecasts is a significant improvement on the industry wide forecasts which were proposed in the April Update Paper. However we believe the regional forecast approach can be, and should be further refined. This is because there is considerable diversity in the historical and expected growth rates for EDBs located within the same region. The following table shows historical throughput and ICP growth rates by EDB, sorted geographically. Neighbouring networks exhibit quite different growth rates. For example, Top Energy and Northpower which are the two Northland regional networks are demonstrably different. This diversity is replicated throughout the country.³

³ Vector and Wellington Electricity are combined in this table.

North Island	Throughput Growth		South Island	Throughput Growth	
	2004 - 2010 (log) p.a.	ICP Growth		2004 - 2010 (log) p.a.	ICP Growth
Top Energy	0.8%	2.2%	Marlborough Lines	3.1%	1.3%
Northpower	1.5%	1.6%	Nelson Electricity	1.1%	0.5%
Vector	1.7%	1.2%	Network Tasman	-3.3%	1.4%
Counties Power	2.2%	1.8%	Buller Electricity	3.0%	1.0%
WEL Networks	3.0%	1.8%	Westpower	7.1%	1.1%
Waipa Networks	1.8%	1.8%	MainPower New Zealand	2.9%	2.5%
The Lines Company	1.9%	-0.5%	Orion New Zealand	1.9%	1.6%
Horizon Energy Distribution	-0.6%	0.7%	Electricity Ashburton	6.1%	2.5%
Eastland Network	0.2%	0.4%	Alpine Energy	3.5%	1.2%
Unison Networks	0.8%	0.9%	Network Waitaki	4.6%	1.1%
Scanpower	-0.6%	0.2%	Aurora Energy	1.2%	1.6%
Centralines	0.5%	1.1%	OtagoNet Joint Venture	2.1%	0.3%
Powerco	2.1%	1.2%	The Power Company	1.8%	1.1%
Electra	2.0%	1.1%	Electricity Invercargill	1.3%	0.3%

30. We note that the EA forecasts are available by GXP and question why the GXP level forecasts have not been used. Additionally population forecasts by territorial local authority (TLA) area would seem to be more relevant than those by region. We therefore submit that in deriving EDB forecasts, the Commission should adopt the most granular forecast available for each measure in order to match as closely as possible network boundaries with the relevant location forecasts.

Minimum Information Requirements

31. Consistent with the points raised above, we consider the Draft Decisions are insufficiently robust due to deficiencies in the information used to project the real revenue growth for each non-exempt EDB. If the Commission is to implement its proposed model, the model must be populated with reasonable information. This is consistent with the low cost objectives of the DPP. For the reasons set out above we do not believe this is the case. Accordingly we submit that:

- The EA's current forecasts are not used in the model to forecast real variable revenue growth. Our recommended solution is to acquire an updated forecast based on GDP and population projections consistent with the NZIER's 2011 forecasts and the MED's energy intensity assumptions. In addition, GXP level forecasts should be used (after allowing for local embedded generation).
- If this is not possible, the EA's data should be abandoned and an alternative solution implemented. We suggest a combination of population and GDP forecasts can be applied to project variable revenue growth, with population growth rates applied to small consumers and GDP to medium and large consumers. The necessary data can be extracted from 2011 information disclosures (Schedule MP3).
- Regional GDP and population forecasts should be abandoned and local TLA forecasts used instead to ensure network level growth rates are used.

Input Price Indices

32. In order to project capex and opex costs, the model relies on input price indices. It is proposed that the Capital Goods Price Index (CGPI) is used for capex costs and a combination of the Producers Price Index (PPI) and Labour Cost Index (LCI) is used for opex costs. Accordingly, the Commission has used forecasts of these indices sourced from NZIER. In applying the forecast indices the Commission has elected to use All Industry forecasts, ie: those which represent over-all economy wide expected price inflation. We have examined the historical movement in the industry wide price indices and compared it to the movement in the sub sector price indices which are most relevant to the electricity distribution sector. The following tables show these comparisons from the beginning of the last regulatory period.

LCI	All Industries Combined	Electricity, Gas, Water and Waste Services
2004 Q2	1.00	1.00
2005 Q2	1.03	1.03
2006 Q2	1.06	1.06
2007 Q2	1.11	1.10
2008 Q2	1.15	1.16
2009 Q2	1.18	1.21
2010 Q2	1.20	1.22

PPI	All Industries Inputs	Power project and substation construction	Power and transmission lines construction
2004 Q1	1.00	1.00	1.00
2005 Q1	1.04	1.07	1.07
2006 Q1	1.11	1.11	1.17
2007 Q1	1.13	1.16	1.35
2008 Q1	1.22	1.22	1.46
2009 Q1	1.27	1.28	1.58
2010 Q1	1.28	1.26	1.76
2011 Q1	1.35	1.30	1.91

CGPI	All Groups	Other construction; Electrical Works	Other construction; Construction of power lines	Other construction; Construction of transmission lines
2004 Q1	1.00	1.00	1.00	1.00
2005 Q1	1.04	1.03	1.11	1.02
2006 Q1	1.07	1.10	1.22	1.15
2007 Q1	1.11	1.14	1.58	1.18
2008 Q1	1.14	1.20	1.78	1.19
2009 Q1	1.19	1.24	1.97	1.24
2010 Q1	1.19	1.28	2.30	1.25
2011 Q1	1.18	1.33	2.52	1.29

33. As noted above, since the beginning of the last regulatory period, EDB sector input price inflation has exceeded that of the economy wide input price inflation in all but one measure. The industry LCI moved ahead from 2008 onwards. The power and transmission lines PPI significantly moved ahead from 2006 onwards, however the power project substation construction has fallen slightly behind the all industries measure since 2010. The CGPI reveals the most dramatic differential, with all three sector indices consistently above the 'All Groups' measure since 2006. Given this divergence it is reasonable to expect that input price inflation for EDBs is likely to exceed industry wide estimates during the next regulatory period, particularly for capex and opex materials.
34. The following chart sourced from Trading Economics shows the movement in copper prices since 2001. Copper is one of the significant inputs for EDBs and copper prices have consistently increased at a faster rate than economy wide CPI, PPI or CGPI since 2001.



35. We note that the Commission has previously considered the relevant input price indices for EDBs, and work undertaken for the Commission by Meyrick and Associates⁴ identified a number of relevant industry indices, the most relevant being the sub sector indices replicated above. If the Commission is to apply its proposed model, then we submit that the model must be populated with relevant information which should include input price forecasts which are relevant for EDBs. In our view the historical trends suggest that industry wide forecasts will understate the cost of opex and capex over the remainder of this DPP period. This results in an unduly harsh decision against the EDBs, as allowable revenue will be understated.
36. Accordingly, we submit that the Commission must acquire updated input price forecasts which are relevant for EDB capex and opex. In this respect we believe the most relevant subsector indices are:
- LCI – Electricity, Gas and Water Sector;
 - PPI – Power Project and Substation Construction and Power and Transmission Lines Construction; and
 - CGPI – Other Construction - Electrical Works, Other Construction - Construction of Power Lines and Other Construction- Construction of Transmission Lines.

Alternative Rates of Change

37. The Draft Decision 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 Draft Decision includes differential rates of change for upwards SPAs only, in order to limit price shock to consumers. This differs to the position in the April Update Paper which proposed that the Commission 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.
38. The alternative rates of change which have been proposed for the four EDBs with material upwards SPAs have been calculated on a NPV neutral basis, ie: the lower SPA in 2012/13 is offset by higher permitted increases in 2013/14 and 2014/15. We submit that a similar mechanism should be available for all EDBs, whether they are subject to positive or negative SPAs, irrespective of materiality. Given the outcome is NPV neutral the Commission should be indifferent to this proposition. Each EDB should be able to consider its own customer base, pricing methodology, expenditure requirements, funding options and reliability

⁴ Meyrick Associates, Indexing the Regulatory Asset Base of Electricity Lines Businesses, 8 July 2005

performance. The proposed SPAs are the first pricing adjustments imposed on EDBs since the first regulatory price controls were implemented in 2003. It is reasonable therefore that all businesses should be permitted some transitional arrangements, albeit only over a three year period.

39. We submit that all EDBs are able to propose alternative rates of change in order to implement the SPA in a revenue neutral manner over the remainder of the DPP.

Proposed Compliance Formula

40. We have considered the proposed compliance formula for determining allowable notional revenue for 2012/13 as set out in the Draft Decision. We believe it needs to be amended in two ways.
41. Firstly the formula incorrectly omits the $R_{t-1} - NR_{t-1}$ revenue adjustment term from the existing DPP price path. This term allows prior period differences between allowable notional revenue (R) and notional revenue (NR) to be brought forward into the following year. This term was introduced for the current assessment period (ie: ending 31 March 2012). Current prices (ie: prices at 1 April 2011) were set consistent with that expectation. Accordingly it is appropriate that these expectations are fulfilled by including the term in the allowable notional revenue for 2013.
42. Secondly we believe that the proposed allowable notional revenue formula for 2012/13 is not consistent with the Draft Decision which is to reset maximum prices in 2012/13 such that an EDB is able to earn a normal rate of return between 2012/13 and 2014/15. The key output of the Draft Decision is the allowable revenue for 2012/13 (and the alternative X factors where these are relevant). Together they solve for the Commission's projected normal returns.
43. As the DPP price path is a weighted average price path, and as the DPP is specified using lagged quantities, the proposed compliance formula also includes a ΔD variable (being 2011/12 and 2012/13 volume growth) used to convert allowable revenue to allowable notional revenue. As the actual volume growth for this period for each EDB is not known, the ΔD variable is based on the real revenue growth assumptions for each non-exempt EDB in the Commission's model. However, unless the actual ΔD for each EDB is exactly the same as the estimated ΔD to be included in the DPP Determination, EDBs will not recover the allowable revenue in 2012/13 consistent with the Decision. If actual volume growth is less than assumed volume growth EDBs will under-recover allowable revenue and vice versa. In the first instance the prices which are consistent with allowable notional revenue will be applied to lower (actual) volumes than included in the allowable notional revenue formula. Thus actual revenues in 2012/13 will be lower than allowable revenue.
44. Accordingly we support the ENA's proposed adjustment term at the end of the DPP to ensure the 2012/13 allowable revenue is recovered consistent with the decision.

Other Proposed Changes to the DPP

45. It is proposed that the DPP determination is updated for a number of changes in addition to the proposed SPA. Specifically 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.

Recoverable Costs

46. We have previously submitted on the definition of recoverable costs, although this submission appears not to have been considered. We repeat our previous concerns and urge the Commission to fully consider these to ensure all businesses are able to include their transmission charges as recoverable costs.
47. 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 its 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

48. 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.
49. In addition the existing DPP includes allowance for recovery of avoided transmission costs where investments have been made which substitute for the Transmission System. These do not form part of the recoverable costs in the DPP IM. However we submit this allowance should be retained for the current DPP as it is consistent with the definition of prices under the current DPP and the expectations of EDBs when they made their investments.

Transactions

50. The draft DPP determination includes new information requirements pertaining to transactions between EDBs subject to the DPP. This is slightly complicated as the DPP IM refers to amalgamations however the DPP also is required to address other forms of transactions (which are not amalgamations). The proposed requirements are somewhat ambiguous, it is not clear what some of the terms such as “other liabilities” refer to and there appears to be a process issue where the Commission’s approval is required before an application is made. We therefore believe in the event of a transaction (whether an amalgamation or otherwise) that the EDBs affected should submit self assessments against their respective DPPs as proposed, in the year of the transaction. Where the transaction is material the Commission should be notified and a compliance arrangement for the following year agreed. We support the ENA’s proposed materiality criteria in this instance.

CPP Applications

51. We also support the ENA’s proposal that the Commission should accept any CPP proposal at any time and apply best endeavours to make a CPP determination as soon as practicable. This includes CPP proposals in response to a catastrophic event in the final year of a DPP.

General

52. 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.

The primary contact for this submission is:

Lynne Taylor
Director
PricewaterhouseCoopers
lynne.taylor@nz.pwc.com
(09) 355 8573