

Submission to the Commerce Commission

on the

**Initial Reset of the Default Price-Quality Path
for Electricity Distribution Businesses
Draft Decisions Paper**

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

12 October 2009

Submission on the Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses Draft Decisions Paper

Under the provisions of the new Part 4 of the Commerce Act 1986 (the Act), the Commerce Commission (the Commission) is required to reset Default Price-Quality Paths (DPPs) for Electricity Distribution Businesses (EDBs) to be effective from 1 April 2010.

Following earlier consultation, the Commission has now released its Draft Decisions Paper: *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses, 8 September 2009* (the Draft Decisions Paper) in this respect.

This paper forms our submission on the Draft Decisions Paper which has been prepared by PricewaterhouseCoopers on behalf of the following 18 EDBs:

- Alpine Energy 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
- The Power Company Limited
- Top Energy Limited
- Waipa Networks Limited
- Westpower Limited.

This group of EDBs together comprises 456,217 connections (or 23% of the total electricity distribution sector), 60,787 system kilometres (41% of the total electricity distribution sector) and \$2.2 billion dollars of regulated network fixed assets (or 28% of the total electricity distribution

sector).¹ The ownership structures represented include consumer and community trusts, a listed company, local body and co-operative ownership, as well as those managed by management companies. Group members include networks with predominantly urban systems, others that are sparsely populated and a number with significant urban areas combined with rural and remote rural characteristics. Some members also have obtained consumer owned exemption status from the DPP requirements, and have chosen to remain engaged in the development of the DPP for the next regulatory period.

Our Submission

- 1 We acknowledge and support a number of the decisions included in the Draft Decision's Paper, in particular those which are consistent with our previous submissions on this topic, as well as those which reflect the recommendations of the ENA, and the supplementary experts' papers provided on behalf of the ENA members in respect of:
 - Total Factor Productivity (TFP) analysis; and
 - measuring reliability performance.

- 2 In addition we acknowledge the inclusion of detailed worked examples in the Draft Decisions Paper, consistent with our earlier submission. These have been most helpful in enabling EDBs to assess how the proposals will impact on their businesses and in addition, we have been able to test the formulae and in some instances propose improvements to them.

- 3 Our submission therefore focuses on those areas where we do not support the Draft Decisions and also where we believe the proposals can be refined and improved. We would welcome the opportunity to discuss the points raised further with the Commission before the Initial DPP Reset Decision is finalised. We also acknowledge and support the additional material to be provided to the Commission in response to the Draft Decisions Paper on behalf of ENA members in respect of TFP analysis and measuring reliability performance.

- 4 Our submission is structured as follows:
 - Section I - A summary of our major comments
 - Section II - Our views on the Draft Decisions and the associated explanatory information contained in the Draft Decisions Paper
 - Section III – Next steps.

¹ Based on 2009 Information Disclosure Data

I Summary

5 We support a number of the draft decisions, and have indicated our support, were relevant throughout the body of this submission. We appreciate the Commission's consideration of a number of the points we have made in previous submissions in this respect. We have listed below a summary of the areas where we believe the draft decisions require further review and modification:

- i. the Initial DPP should provide for excluded services where there is workable competition for the services, consistent with section 54C of the Act and where there is written agreement from the consumer to remove them from the price path;
- ii. provisions for re-openers for unforeseen and uncontrollable events which affect some or all of the industry should be included in the Initial DPP;
- iii. lagged quantities used in the price path formula should be the t-2 option to better meet the certainty objectives and avoid the impact of estimates and wash-ups present in the t-1 option;
- iv. forecast not lagged CPI should be used in the price formula to avoid double counting the impact of the low inflation experienced in 2009. A simple adjustment mechanism should be added to the price path formula to account for differences between forecasts and actual inflation;
- v. the formula for the lagged CPI option in the draft decision is incorrect;
- vi. the Allowable Notional Revenue formula in the draft decision is incorrect as it fails to anchor opening prices as starting prices for the entire DPP period which is inconsistent with a price path;
- vii. we have included suggested improvements and corrections to the price path formula in the body of the submission;
- viii. additional pass through costs for costs associated with new levies or regulations should be provided for, to be applied for and approved by the Commission in the prior year;
- ix. the long range productivity trend implicit in the TFP analysis incorporates substantial productivity gains achieved by EDBs following the Electricity Industry Reform Act (1998). It is unreasonable to expect such structural gains to be replicated in future years;
- x. we endorse the additional comments on the rate of change analysis provided by Pacific Economics Group on behalf of the ENA;
- xi. the impact of zero event days on the quality assessment performance for New Zealand EDBs requires more careful consideration. We support the additional work undertaken by Statistics Research Associates on behalf of the ENA in this respect;

- xii. we do not agree that the Major Event Day substitution approach for normalising quality assessments for extreme variations will have a relatively neutral impact on EDBs;
- xiii. the SAIFI standard should include normalisation for Major Event Days on the basis of SAIFI data not SAIDI data as proposed;
- xiv. additional quality standards should not be included for non-contiguous networks as this is inconsistent with the price path, inequitable and not justified as non-contiguous quality data is available through information disclosures;
- xv. we submit that the DPP Reliability Target should be set to no less than 80% of the 1999 -2003 threshold benchmark (using data normalised for extreme events for both datasets) for those EDBs which have reported a 20% or more improvement in reliability between the two periods. No price adjustments have been possible under the thresholds to reflect this improved reliability and it is not possible to determine whether the improvements are sustainable;
- xvi. we support the planned future work streams and encourage the Commission to undertake these as soon as possible, with the objective of incorporating refinements to the Initial DPP within the regulatory period;
- xvii. the Enforcement Guidelines should be consulted upon and published prior to the commencement of the Initial DPP; and
- xviii. the proposed technical consultation period for the Initial Reset Determination is too short, and information needs to be provided to interested parties at an earlier date.

II The Draft Decisions

Regulatory Framework – Purpose and Principles

6 We support the following aspects of the Draft Decisions:

- the Commission's interpretation of the Part 4 Purpose Statement as set out in paragraph 2.3 of the Draft Decisions Paper;
- the definition of consumer as set out in paragraphs 2.5 – 2.6 of the Draft Decisions Paper;
- the specific consideration of the section 53K purpose of default/customised price-quality regulation in particular that the DPP should be a generic tool that can be applied across multiple suppliers; and
- consideration of the economic and implementation principles set out in section 2.4 of the Draft Decisions Paper.

7 In respect of the standard of workable competition we support the submission made by the ENA on the DPP Discussion Paper² in respect of excluded services. Currently the price path threshold provides for EDBs to exclude certain services from the price path where there is evidence to support the existence of workable or effective competition for the services. In our view this is entirely consistent with the standard of workable competition that underpins Part 4 and we would expect provisions for excluded services to be included in the Initial DPP Decision. In this respect we support the ENA's proposal to include in such a definition the provisions of section 54C and in addition, provisions for excluded services where there is written agreement between the supplier and the consumer to remove them from the DPP.

Regulatory Framework - Considerations for the Reset DPP

8 We support the following aspects of the DPP Draft Decision:

- recognition of the Government Policy Statements (GPS) on electricity governance and Infrastructure investment incentives;
- consideration of the section 54Q requirements for energy efficiency;
- flexibility for EDBs to set different price structures within a Notional Revenue constraint;
- the inclusion in the DPP of a provision for re-openers;

² Electricity Networks Association, Submission on the Reset of the DPP for Electricity Distribution Businesses, 17 July 2009, pages 8-11

- a single price-quality path (subject to our comments below on the development of an S-factor mechanism); and
 - to incorporate customer communications criterion in information disclosure requirements rather than the DPP.
- 9 In respect of section 54Q we fully support the proposals to investigate further possible mechanisms to address the section 54Q requirements in the DPP. We urge the Commission to undertake this work as soon as possible, with the objective of modifying the DPP during the forthcoming regulatory period to include more specific provisions than those that have been able to be included at this time. We fully support the suggestions put forward by the ENA in this respect,³ and encourage the Commission to undertake workshops with industry representatives to discuss how such incentive mechanisms may be developed as part of the Initial DPP. The EDBs which support this submission would welcome the opportunity to contribute to this work stream.
- 10 We are concerned that there will be no provision for re-openers until after the IMs have been determined. There is an equal risk that events which may require a re-opener will occur in the first year of the DPP as the second or subsequent years. It is inequitable for re-openers to be excluded from one period of the DPP and included in another. In our view, re-openers should be provided for in the interim, prior to the IM determinations, as a precautionary measure. These should include provision for re-openers for unforeseen and uncontrollable events, exogenous to the supplier, and of a material nature. These should not be limited to events which affect the industry as a whole as suggested in the Draft Decisions Paper, as local catastrophes or events, such as a major earthquake, could be severe enough to require a re-opener for one or a few EDBs. Such events impact on cost and revenue in addition to quality and are not appropriate for a customised price-quality path (CPP), because they reflect immediate events and have immediate consequences.
- 11 We continue to support the development of an S-factor mechanism which could be elected by EDBs seeking to improve their reliability, and receive appropriate financial rewards for such actions. We support the intention to undertake further work in this area in 2010 and the EDBs which support this submission would like to contribute to this project. We suggest this is a further topic which would benefit from a workshop environment, as opposed to a traditional consultation paper process.

³ Ibid, page 4 and Electricity Networks Association, Energy Efficiency Incentive Issues, 18 May 2009

Price Path

12 We support the following aspects of the DPP Draft Decision in respect of the price path:

- a price-path in the form CPI-X;
- use of a weighted average price cap;
- a definition of price consistent with the current Thresholds Notice (subject to our earlier comments on excluded services);
- no unbundling of distribution from transmission revenues for the purpose of the price path;
- use of lagged quantities which are matched to a pricing year in the derivation of Notional Revenue (although we support the t-2 option as opposed to the t-1 option as discussed below);
- the inclusion of pass through costs for transmission (including avoided transmission), local body rates and Electricity Commission and Commission levies; and
- Commerce Act levies paid by EDBs during 2009/10 amortised and included as pass through costs evenly over the regulatory period.

13 We are concerned that the proposed t-1 approach to lagging quantities for the price path will not achieve the certainty objectives which are being sought. Although quantities will be known for about two thirds of the year at the time prices are set (and hence estimates for the last four months will need to be made) unfortunately the information available to EDBs at that time reflects only estimated quantities, which will subsequently change due to wash ups and reconciliations. It is common for such adjustments to be material, particularly at year end. We accept that a t-2 approach decreases the comparability between the assessment and actual quantities, but we believe this additional 12 month lag is acceptable given the additional certainty it will provide for the DPP, thus reducing the number of technical breaches. This proposal also avoids the additional compliance cost associated with the proposals for disclosure (and audit) of estimated and actual quantities for under the t-1 approach.

14 In addition, we do not support the proposal for the price path to be indexed using a lagged CPI. We accept that the lagged CPI will, over time, accurately reflect underlying inflation. It will however, if implemented as proposed in the Draft Decision Paper, double count the inflation which applies during the 2009, as this will apply in the existing price path (for the period ending on 31 March 2010) and the first year of the initial price path (for the period ending on 31 March 2011). As we are currently experiencing some of the lowest inflation in over a decade, it is unreasonable to set regulated prices on this basis.

15 Accordingly, we support the forecast inflation option for the price path, which can be implemented with a simple adjustment factor to accommodate the difference between forecast

and actual inflation in the following year. Our detailed submission on the price path formulae is presented later in this submission.

16 In addition we note that the specification of the price path formula set out in Appendix B of the Draft Decision Paper has the effect of rebasing prices each year to actual prices for the purpose of establishing Allowable Notional Revenue. This is change to the form of the price path from that contained in the current thresholds. It has the effect of removing any headroom which may have existing in the previous year, from the Allowable Notional Revenue in subsequent years. It also locks in any breach of the DPP prices into the Allowable Notional Revenue in subsequent years. We do not believe this is reasonable nor the intention of the price path. Although the changes that are proposed in terms of quantities and CPI have the effect of removing sources of uncertainty from the price path, they cannot remove all uncertainty. Not all pass through costs will be known when prices are set for example. Given the consequences of failing to comply with the DPP are more severe than breaching the thresholds, EDBs may also choose to be conservative, particularly in the early years of the DPP, where the consequences of non compliance are not well understood, and the mechanics of the formula untested. In addition, some EDBs may choose not to increase prices up to the full allowance in every year for other reasons specific to their own networks.

17 Potential revenue forgone in one year should be able to be achieved in subsequent years, as has been the case in the price path threshold. Our suggested changes to the price path formula are included later in this submission.

18 We note that the Draft Decision Paper has not acknowledged our earlier submission that provision for additional pass through of new levies or costs resulting from legislative changes should be provided for, similar to the Gas Authorisation. Under the Gas Authorisation a pipeline business applies to the Commission prior to the start of the pricing year for pre approval of additional pass through costs. A similar mechanism should apply in the DPP.

Starting Prices

- 19 We support the following aspects of the DPP Draft Decision in respect of starting prices:
- starting prices based on actual posted prices as at 31 March 2010; and
 - any potential adjustments to starting prices will take place after the determination of IMs.

Rate of Change

20 We support the following aspects of the DPP Draft Decision in respect of the rate of change:

- that the results of the TFP analysis in respect of past productivity have been used to inform the rate of change decision, and have not been applied mechanistically;
 - consideration of the two alternative approaches (presented by Economic Insights (EI) and Pacific Economics Group (PEG)) in forming the decision; and
 - the draft decision that the rate of change should be set to 0% for the next regulatory period.
- 21 We continue to be concerned however, that the EI approach reflects a new and untested approach, which differs from the traditional and former B-factor approach. We support the ENA's initiative in engaging PEG to provide more detailed comments in respect of the Draft Decision in this respect.
- 22 We also note that in accepting the longer range productivity trend which includes the 1998 – 1999 period the Commission has locked in the one off gains reported by the distribution sector as a result of the Electricity Industry Reform Act (1998) which forced the ownership separation of lines from energy and generation businesses. This structural change resulted in significant productivity improvements at that time which can be observed in the data series produced by PEG. It is unrealistic to expect that the same level of productivity gains can be replicated in future years and we therefore question the relevance of the early period of the productivity trend data for the purpose of defining future productivity expectations.

Price Path Formulae

- 23 We appreciate the inclusion of worked examples of the price path formulae in the Draft Decision Paper and have found this most helpful in considering the draft decisions.
- 24 We suggest the following modifications to the proposed price path formula. Each of these has been presented independent of each other for clarity.

Forecast CPI

- 25 To implement forecast CPIs into the calculation of R , including an adjustment to reflect the difference between forecast and actual CPI in previous periods, we suggest the following calculation of Δ CPI:

$$\Delta\text{CPI}_t = \underbrace{(1 + \Delta\text{CPI}_{f,t-1})}_{\text{Forecast Change}} \times \underbrace{\frac{(1 + \Delta\text{CPI}_{a,t-2})}{(1 + \Delta\text{CPI}_{f,t-2})}}_{t-2 \text{ Adjustment}} - 1$$

- where: ΔCPI_t is the change in CPI used in the calculation of R_t
 $\Delta\text{CPI}_{f,t-1}$ is the forecast change in CPI for the year ending September_{t-1} (from Statistics NZ, the Reserve Bank or similar)
 $\Delta\text{CPI}_{f,t-2}$ is the forecast change in CPI for the year ending September_{t-2}
 $\Delta\text{CPI}_{a,t-2}$ is the actual change in CPI for the year ending September_{t-2}, specified as:

$$\Delta\text{CPI}_{a,t-2} = \frac{\text{CPI}_{\text{Dec},t-3} + \text{CPI}_{\text{Mar},t-2} + \text{CPI}_{\text{Jun},t-2} + \text{CPI}_{\text{Sep},t-2}}{\text{CPI}_{\text{Dec},t-4} + \text{CPI}_{\text{Mar},t-3} + \text{CPI}_{\text{Jun},t-3} + \text{CPI}_{\text{Sep},t-3}}$$

26 The *t-2* adjustment set out in the calculation above performs an adjustment to R_t to reflect the difference between forecast CPI for the year ending September_{t-2} (as utilised in the calculation of R_{t-1}) and actual CPI for the year ending September_{t-2}. This adjustment is effectively undertaken on an eighteen month lag basis due to the lack of actual CPI data required to perform a one-period lagged adjustment. As an eighteen month lag adjustment is used, there should be no *t-2* adjustment in the calculation of ΔCPI_{11} as in this cases *t-2* refers to the assessment period within the existing regulatory period.

27 Set out below is a worked example of the suggested CPI formula for the calculation of ΔCPI_{13} :

$$\Delta\text{CPI}_{13} = (1 + \Delta\text{CPI}_{f,12}) \times \frac{(1 + \Delta\text{CPI}_{a,11})}{(1 + \Delta\text{CPI}_{f,11})} - 1$$

28 Assuming that forecast CPI for the year ending 30 September 2012 ($\Delta\text{CPI}_{f,12}$) is 3%, forecast CPI for the year ending 30 September 2011 ($\Delta\text{CPI}_{f,11}$) was 2.5% and the actual CPI for the year ending 30 September 2011 ($\Delta\text{CPI}_{a,11}$) was 2%, the resulting CPI adjustment would be:

$$\Delta\text{CPI}_{13} = (1 + 3\%) \times \frac{(1 + 2\%)}{(1 + 2.5\%)} - 1 = 2.498\%$$

29 This calculation allows for forecast CPI over the pricing period (3%) but also adjusts R_{13} to recognise that the forecast CPI incorporated into the calculation of R_{12} was higher (2.5%) than was actually experienced (2%). ΔCPI_{13} can therefore be disaggregated into the R_{13} forecast CPI (3%) and the adjustment to the R_{12} CPI forecast (~ -0.5%).

Correction to Lagged CPI Formula

30 Notwithstanding the suggested alternative CPI calculation set out in paragraph 34 above, we believe the timing implied in the CPI derivation formula (Formula 8) for the Commission's preferred lagged CPI approach appears to be incorrect. The draft DPP discussion and the example on page 137 indicates the following formula should be applied (which differs to formula 8 in the Decisions Paper):

$$\Delta\text{CPI}_t = \frac{\text{CPI}_{\text{Dec},t-3} + \text{CPI}_{\text{Mar},t-2} + \text{CPI}_{\text{Jun},t-2} + \text{CPI}_{\text{Sep},t-2}}{\text{CPI}_{\text{Dec},t-4} + \text{CPI}_{\text{Mar},t-3} + \text{CPI}_{\text{Jun},t-3} + \text{CPI}_{\text{Sep},t-3}} - 1$$

31 Set out below is an example of the restated formula applied to the assessment of ΔCPI for the year ending 31 March 2011 (i.e. for FY11, $t = 11$). In this particular case, the timing for setting FY11 prices (i.e. the period 1 April 2010 to 31 March 2011) would be in December 2009. As such, actual quarterly CPI data would only be available up to the September 2009 quarter. The specification of the ΔCPI formula for FY11 would therefore be:

$$\Delta\text{CPI}_{11} = \frac{\text{CPI}_{\text{Dec},08} + \text{CPI}_{\text{Mar},t-09} + \text{CPI}_{\text{Jun},t09} + \text{CPI}_{\text{Sep},09}}{\text{CPI}_{\text{Dec},07} + \text{CPI}_{\text{Mar},08} + \text{CPI}_{\text{Jun},08} + \text{CPI}_{\text{Sep},08}} - 1$$

t-2 Quantities

32 In order to perform the calculation of R and NR utilising two-period lagged quantities, the Allowable Notional Revenue and Notional Revenue calculations should be specified as follows:

$$R_t = (\sum P_{i,t-1} Q_{i,t-2} - K_{t-1}) \times (1 + \Delta\text{CPI})(1-X)$$

$$NR_t = \sum P_{i,t} Q_{i,t-2} - K_t$$

33 The two-period lagged quantities would increase the accuracy of the Q's utilised in the calculation of NR. We have also tested the impact of this approach on the pass through cost anomaly.

- 34 The pass through anomaly is associated with the portion of price that relates to the recovery of pass through costs. When prices are set based on non-current quantities, the prices calculated will, in most cases, be different to that which would be set if current quantity information was available. For companies experiencing quantity growth, the use of historical quantities (which are smaller) will result in slightly higher prices being calculated to recover pass through costs than would be the case if current quantities were utilised in the calculation of prices. The opposite situation occurs when quantities are decreasing.
- 35 The problem with using current or even one-period lagged quantities is that these quantities will involve some level of estimation or forecasting and lack the certainty provided by two-period lagged quantities. The accuracy in calculating prices can therefore be considered partly as a trade-off between the magnitude of the quantity forecasting error versus the magnitude of the pass through anomaly.
- 36 An algebraic comparison of using one-period lagged quantities and two-period lagged quantities using the example set out on page 135 the Draft Decisions Paper is set out below. More realistic Q growth rates of 3% have been substituted however for the 30% growth rates utilised in the Decisions Paper.

Assessment Period ending:	31 March 2010	31 March 2011	31 March 2012
Price	$P_{10} = 10.0$	$P_{11} = 10.3$	$P_{12} = ?$
Quantity	$Q_{10} = 10.0$	$Q_{11} = 10.3$	$Q_{12} = 10.6$
Pass-through Costs	$K_{10} = 30.0$	$K_{11} = 35.0$	$K_{12} = 40.0$

The calculation of Allowable Notional Revenue assumes $(1+\Delta\text{CPI})(1-X) = 1.05$:

- 37 Using a one-period lagged quantity calculation would produce the following result:

$$\begin{aligned}
 R_{12} &= (P_{11}Q_{11} - K_{11}) \times (1+\Delta\text{CPI})(1-X) \\
 &= (10.3 \times 10.3 - 35.0) \times 1.05 \\
 &= 74.645
 \end{aligned}$$

$$\begin{aligned}
 \text{If } NR_{12} &= P_{12}Q_{11} - K_{12} \\
 \rightarrow P_{12} &= (NR_{12} + K_{12}) / Q_{11}
 \end{aligned}$$

Setting $NR_{12} = R_{12}$:

$$\begin{aligned}
 P_{12} &= (74.645 + 40.0) / 10.3 \\
 &= \mathbf{11.131}
 \end{aligned}$$

- 38 Using a two-period lagged quantity calculation would produce the following result:

$$\begin{aligned}
 R_{12} &= (P_{11}Q_{10} - K_{11}) \times (1 + \Delta\text{CPI})(1-X) \\
 &= (10.3 \times 10.0 - 35.0) \times 1.05 \\
 &= 71.400
 \end{aligned}$$

$$\begin{aligned}
 \text{If } NR_{12} &= P_{12}Q_{10} - K_{12} \\
 \rightarrow P_{12} &= (NR_{12} + K_{12}) / Q_{10}
 \end{aligned}$$

Setting $NR_{12} = R_{12}$:

$$\begin{aligned}
 P_{12} &= (71.400 + 40.0) / 10.0 \\
 &= \mathbf{11.140}
 \end{aligned}$$

- 39 The results of these calculations demonstrate the pass-through anomaly, where using older quantity information in a situation where quantities have positive growth leads to slightly higher calculated prices. The opposite would be true if quantities were decreasing.
- 40 However, the example above shows only a \$0.009 or 0.08% difference in prices between the two approaches, which when put in terms of an EDB with \$10 million of network revenues result in increased revenues of only \$8,000. As two-period lagged quantities are known with certainty, the use of those quantities will avoid any technical breaches of the price path that might occur as a result of the forecasting errors associated with the use of one-period lagged quantities. As demonstrated above, the use of two-period lagged quantities has an immaterial impact on pricing in respect of pass through costs.

Anchoring Allowable Notional Revenue to 2010 Starting Prices

- 41 As indicated in paragraph 16 above, we believe the price path has been incorrectly specified as it fails to anchor starting prices throughout the entire period of the DPP. We believe the calculation required to anchor starting prices throughout the DPP, avoid rebasing prices each year, and hence appropriately reflect any headroom or breach beyond the first year of the reset period should be specified as follows:

$$R_t = (\sum P_{i,t-1} Q_{i,t-1} - K_{t-1} + R_{t-1} - NR_{t-1}) \times (1 + \Delta\text{CPI})(1-X)$$

- 42 The $R_{t-1} - NR_{t-1}$ component of the formula allows for the carry forward of any breach or headroom position into the calculation of R beyond the first year of the new reset price path period. Given Notional Revenue calculated at 31 March 2010 (using 31 March 2010 prices) is proposed to be used as the base for the calculation of Allowable Notional Revenue in for the reset price path, $R_{t-1} - NR_{t-1}$ should be set to zero in the first year of the reset period (i.e. t=11).

43 Adopting this formula will avoid the situation of a price path breach being rolled into the calculation of subsequent year's Allowable Notional Revenue and allowing an EDB to effectively continue to be able to maintain a breach position within its tariff structure. It will also ensure EDBs have the ability to recover forgone revenue in future years if they choose to, consistent with the intention of a five year CPI-X price path. As noted above, we expect EDBs will be cautious in setting prices, particularly in the early years of the DPP, when the consequences of breaches are not well understood and the mechanics of the DPP formula untested.

Quality Standards

44 We support the following aspects of the DPP Draft Decision in respect of quality standards:

- quality standards will be defined using own network SAIDI and SAIFI reliability performance;
- quality standards will be set on the basis of a no material deterioration standard;
- the reference dataset will be based on the daily SAIDI and SAIFI data for the period 1 April 2004 – 31 March 2009 (subject to the qualification outlined in paragraph 27 below);
- that normalisation for extreme variation should be incorporated into the quality standard and annual assessments;
- that normal variation should be accounted for through the use of a dead-band, to be based on one times the standard deviation present in the normalised reference dataset; and
- that the compliance assessment is based on an annual assessment (quality performance in the year is less than the quality standard) or assessed values in the previous two assessment periods are less than the quality standards.

45 We remain extremely concerned however about the definition of extreme events, which is contrary to the proposals put forward by the ENA's statistical advisor Statistics Research Associates (SRA). In particular we are concerned that the Commission has misunderstood the significance of the impact of the zero event days on the reliability performance outcomes for a number of EDBs. Although the initial SRA report provided evidence for Auckland and Wellington networks, we understand SRA has now submitted further evidence, on behalf of the ENA which illustrates this impact across a wider group of networks. We support the additional information presented in SRA's report and urge the Commission to seriously consider this expert input before it publishes its final decisions.

46 In addition, in considering submissions on the substitution for Major Event Days (MEDs) in the context of extreme event normalisation, the Draft Decision Paper does not agree with proposals put forward by SRA, and has concluded that given the substitution method

recommended (replacing MEDs with the boundary value) will be applied in the reference data as well as the annual assessment, the impact will have a relatively neutral impact on compliance. We accept that in principle this seems reasonable, however it assumes that the frequency of major events is consistent between the reference period and the assessment period. By their very nature, extreme events are unpredictable, and hence it is unlikely that this assumption will have a neutral impact on all EDBs.

47 We do not support the draft decision to normalise for extreme events for SAIFI by identifying MEDs using SAIDI data, and replacing SAIFI values on those days, if SAIFI exceeds the boundary. This approach assumes that extreme events will impact on SAIDI and SAIFI in similar ways. This approach appears to have been influenced by Vector's analysis of its own network which demonstrated that over ten years there were no instances where SAIFI has breached independently of SAIDI. Notwithstanding this analysis, the experience has not been the same for all other networks. Smaller networks are vulnerable to localised events which can have a significant impact on reliability, particularly those with a larger portion of overhead reticulation than Vector. Some events, such as wind storms, can have a disparate impact on SAIFI compared to SAIDI. This is evidenced in the threshold breaches to date as illustrated below.

EDB Quality Breaches	2005	2006	2007	2008	2009	All Years
Breached both SAIDI and SAIFI	4	5	8	8	9	58%
Breached SAIDI & Complied with SAIFI	1	2	2	7	4	28%
Complied with SAIDI & Breached SAIFI	0	2	3	2	1	14%
Total	5	9	13	17	14	100%

48 The table above indicates that of the total quality threshold breaches reported between 2005 and 2009, 42% reflected a breach of one or other of the thresholds, but not both. Of these 14% represented a breach of the SAIFI threshold and not the SAIDI threshold. For this reason we do not support the proposed approach for normalising SAIFI for extreme events. It is possible to apply the same MED criteria to the SAIFI data as it is to the SAIDI data and we submit this should be the approach adopted for normalising for extreme events for the quality path. As submitted previously, a breach of either the SAIDI or the SAIFI standard is a breach of the DPP. It is therefore important that both measures are treated consistently when normalising for extreme variations.

49 We note that paragraph 7.22 of the Draft Decisions Paper includes a draft decision that non-contiguous networks will be required to derive separate SAIDI and SAIFI standards. This recommendation was unexpected and discussion on this issue was not included in the Commission's 19 June 2009 DPP Reset Discussion Paper. We have considered the draft decision and do not support it for the following reasons:

- The DPP is a combined price-quality path. This reflects the inherent relationship between the cost of, and prices charged for, electricity conveyance services and the quality of service provided. In order to ensure EDBs do not compromise quality to achieve regulated price constraints, a standard of no material deterioration has been assumed for the quality path. For the price path, a Notional Revenue approach has been adopted which effectively constrains average prices. The price path has not been set on a non-contiguous network basis, and nor should it be. The quality path must be defined on the same basis, as it is this inherent relationship between price and quality which the DPP represents.
- Compliance with the DPP will require compliance with price, SAIDI and SAIFI paths in every year. A breach of one constitutes a breach of the DPP. For those EDBs with non-contiguous networks (say network North and network South), compliance with the DPP under the proposed draft decision will require compliance with price, SAIDI North, SAIDI South, SAIFI North and SAIFI South. A breach of one will constitute a breach of the DPP. Notwithstanding the normalisation to be incorporated into the quality standards, the additional quality standards will increase the likelihood of a breach for those EDBs affected. As the implications of a breach of the DPP are significantly more severe than those under the Part 4A thresholds regime we submit this is an unreasonable and unnecessary proposal.
- The Information Disclosure Requirements (2008) require EDBs with non-contiguous networks to disclose SAIDI and SAIFI performance for each non-contiguous network. This is appropriate and sufficient.

50 Finally, we note that some EDBs have recorded substantial improvements in their reliability performance over the reference period (2005-2009). It is not yet possible to determine whether these improvements reflect levels of reliability which are sustainable in the long term. In addition these EDBs have been unable change prices to reflect this improved reliability (without breaching the thresholds). We do not have access to data normalised for extreme events for the 1999 – 2003 and 2005 – 2009 periods, but the raw data shows the following EDBs⁴ with improvements in average reliability of 20% or more between the two periods.

⁴ Not all of these EDBs are subject to the DPP, as some have consumer-exempt status.

EDB	SAIDI Threshold 5 Year Average 1999 - 2003	2005-2009 Average SAIDI	2005-2009 % Change to SAIDI Threshold
Nelson Electricity	61	48	-21%
WEL Networks	110	84	-24%
Eastland Network	367	275	-25%
Scanpower	83	56	-32%
Buller Electricity	343	197	-43%
Waipa Networks	273	170	-38%
Centralines	313	171	-45%
The Lines Company	537	280	-48%

EDB	SAIFI Threshold 5 Year Average 1999 - 2003	2005-2009 Average SAIFI	2005-2009 % Change to SAIFI Threshold
Network Tasman	2.1	1.5	-29%
Buller Electricity	2.4	1.6	-36%
WEL Networks	2.0	1.6	-21%
Eastland Network	3.6	3.2	-12%
The Power Company	4.3	3.4	-22%
Waipa Networks	3.2	2.5	-23%
Centralines	5.8	4.0	-31%
Nelson Electricity	1.3	0.8	-40%
The Lines Company	6.3	3.6	-43%

51 Due to the magnitude of the difference between the threshold benchmark period and the proposed reference period for the DPP for the EDBs listed above, we submit that the DPP Reliability Target should be set to no less than 80% of the threshold benchmark (using data normalised for extreme events for both datasets) for those EDBs which have reported a 20% or more improvement in reliability between the two periods.

Initial Reset Determination

52 We support the following aspects of the DPP Draft Decision in respect of the Initial DPP Determination:

- that a single Determination is to be published;
- that the regulatory period will be five years;
- that compliance assessments are to be provided within 50 working days of each assessment date in the regulatory period; and
- to exclude from the initial determination an annual submission date for CPP proposals.

Future Work

53 We support the proposals for the Commission to undertake future work on the topics listed below and urge the Commission to progress these work streams as quickly as possible, with a view to incorporating the findings into the initial DPP at some stage during this regulatory period:

- Starting price adjustments
- Claw-back mechanisms
- Energy efficiency mechanisms
- S-factor mechanism
- Enforcement Guidelines.

54 In our opinion, the Enforcement Guidelines are the most crucial of all these topics, and they should be available before the Initial DPP comes into effect. It is not appropriate for EDBs to be subject to binding regulation without fully understanding the consequences of not complying with those requirements. We therefore urge the Commission to consult on and finalise these before 1 April 2010.

55 In addition and as previously noted, the EDBs which support this submission would welcome opportunities to work with the Commission to further develop the thinking on the topics listed above. We believe that workshops and dialogue between the Commission and industry representatives are useful processes for such work streams and we encourage the Commission to consider alternative processes to its traditional consultation paper/submission approach for this purpose.

III Next Steps

- 56 We look forward to the Updated Draft Decisions Paper due mid November. We note that this will be accompanied by a Draft Initial Reset Determination which will be subject to a technical drafting consultation period of one week. We support the provision for technical drafting consultation but believe one week is insufficient for this purpose. History has shown that errors are made in the technical drafting of regulatory notices. Given we have not yet seen a significant amount of information that will need to be included in the determination (for example: definitions of terms; information to be included in compliance assessments; requirements for auditors and directors; form of auditors opinions; specific clauses for each of the price and quality paths) there will be a considerable amount of material to consider, and crosscheck within that limited technical drafting period.
- 57 We therefore suggest that prior to mid-November, at least part of the determination be released for technical drafting consultation. This could include all components except the specific clauses for each of the price and quality paths, if final decisions had not been reached on the price and quality paths at that time.
- 58 In any event it would be most helpful if the Commission were able to provide well in advance the exact date that the Draft Initial Reset Determination is to be published. This will enable interested parties to ensure they have the appropriate resources available for this limited consultation period.

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