

Submission to the Commerce Commission

on the

**Initial Reset of the Default Price-Quality Path
for Electricity Distribution Businesses
Consultation Update Paper**

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

20 November 2009

Submission on the Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses Consultation Update 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.

In September the Commission released its Draft Decisions Paper: *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses, 8 September 2009* (the Draft Decisions Paper). Our submission on the Draft Decisions Paper was submitted on 12 October 2009. In response to that, and other submissions, the Commission subsequently released a preliminary Draft Determination Consultation Paper: *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses, Initial Reset Determination (DRAFT), Consultation Paper, 16 October 2009* (the Draft Determination). Our submission on the Draft Determination was submitted on 3 November 2009. The Commission has now issued an Update Paper: *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses, Consultation Update Paper, 16 November 2009* (Update Paper) which includes a final draft of the DPP determination. The purpose of this paper is to provide the Commission's views and responses to the submissions received to date and to seek final comments on the technical drafting of the DPP determination.

This paper forms our submission on the technical drafting of the Final Draft Determination contained in the Update Paper. It 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 As requested we have limited our comments to those relevant to the technical drafting of the Determination. We note this has been complicated by the short time available for the consultation, the significant changes introduced into the Determination since the previous draft (many of which we support in principle, however the widespread changes have increased the scope of the technical review we must complete within the week provided for the consultation), and the lack of a Final Decisions Paper against which the Draft Determination can be assessed. The Commission's intention is not clear in some instances in the Draft Determination and without the accompanying Decision we may not have fully understood the requirements embodied in the Determination. We have attempted to highlight potential areas of ambiguity in this and our previous submissions.
- 2 Our submission is limited to comments on the Draft Determination in the areas where we believe changes are required to fully implement the Decisions and allow EDBs to comply with these in a meaningful way.

¹ Based on 2009 Information Disclosure Data

- 3 Our submission is structured consistent with the Draft Determination. We have also included in Appendix A our suggested drafting for clauses in the Draft Determination which we believe contain errors, or should be changed to clarify their intent.

Clause 4 - Interpretation

4 The **Assessment Dataset** and **Reference Dataset** definitions have been amended to clarify that multi-day events are accrued to the first day. The definition also needs to clarify that where storms cause ongoing interruptions, they are accrued to the first day of the storm.

5 Our previous submission on the definition of **Avoided Transmission Charges** has not been adopted. The Update Paper does not indicate why our suggestions have been rejected. We continue to believe that the proposed definition is inconsistent with the Draft Decisions.

Paragraph 4.69 of the 8 September 2009 Draft Decisions Paper states:

The boundary between transmission and distribution systems, which are to some extent substitutes, can change over time, and it is possible that some movements in transmission costs will be offset by opposite movements in distribution costs. In addition to boundary changes, transmission charges may be partially avoided through the development of distributed generation. The Commission considers that avoided transmission charges, including as a result of the transfer of assets from Transpower to an EDB or the development of distributed generation, should continue to be treated as pass-through costs.

6 The Draft Determination however does not include provision for EDBs to recover the avoided transmission charges that result from a transfer of assets from Transpower to an EDB. This is a disincentive to an opportunity for efficiency gains and therefore we believe inconsistent with the Purpose Statement as well as the Draft Decisions.

7 The Update Paper has adopted our suggestion that references to Electricity Distribution Service be changed to references to **Electricity Lines Service** as provided for in the Act. The Update Paper has not however accepted our submission that provision for Excluded Services should be retained (as per the current Thresholds Gazette Notice) although the Update Paper provides little explanation in this respect. This is causing some confusion for EDBs regarding the scope of services covered by the price path. For example, it is not clear what the Commission intended when it states, in Appendix A, Row 3:

The Commission agrees with submissions that some of the services excluded under the Thresholds continue to be excluded under Part 4 by virtue of the electricity lines services definition.

We therefore request that the Final Decision Paper clarifies this position by setting out the services which the Commission now believes are included in the DPP which were excluded under the Thresholds.

- 8 The definition of **Pass-Through Costs** introduces a compliance standard *“to the satisfaction of the Commission”* which is unnecessary and unworkable in the context of an Annual Compliance Statement and the associated audit opinion. By setting out the compliance requirements in the Determination, and requiring these to be audited, the Commission is setting its standards for the entire DPP. This is explicit in the requirement for EDBs to comply with the Determination, publish Annual Compliance Statements and have them audited.
- 9 Neither the EDB preparing the Annual Compliance Statement nor the auditor is able to assess whether the *“to the satisfaction of the Commission”* standard has been met during the preparation and audit of the Annual Compliance Statement. This can only occur if the Commission is prepared to engage with the EDB and agree (or otherwise) that this standard has been met prior to the submission of the Annual Compliance Statement. To date the Commission has been unwilling to engage on compliance matters in this manner. We therefore submit that this term must be removed from the Determination. The same comment applies in respect of Clause 10.3 regarding evidence of compliance where a merger or acquisition has occurred.
- 10 If the Commission intends to persist with this term in the Determination then there needs to be specific exclusions for the Non-exempt EDB preparing the Annual Compliance Statement and both the auditors and directors in forming views on whether the *“Commission’s satisfaction”* standard has been met. A similar exemption was included in Clause 7(2)(b) of the Thresholds Gazette Notice.
- 11 In addition we submit that the pass through cost term requires clarification in respect of the inclusion of the 2009/10 Commerce Act Levies (as per Clause 8.6). This is because the 2009/10 Commerce Act Levies do not meet the definition *“paid or payable during an Assessment Period”*.
- 12 We note the definition of **Transmission Charge** now excludes Loss and Constraint Rentals which have been a source of considerable uncertainty for EDBs when estimating pass through costs. We support this exclusion.
- 13 We also note that although the definition of transmission charges has changed from the earlier version it retains a direct link to charges made by Transpower. Nelson Electricity has no

contract with Transpower, as it has no connection to the Grid however it incurs a proportion of Transpower's transmission charges, incurred by its neighbour Network Tasman, which are passed on directly to them. The definition of transmission charges therefore requires amendment to replace references to Transpower, to references to the Transmission System. If this change is not made, Nelson Electricity will have no transmission component in its pass through costs.

- 14 A similar issue applies to the definition of new investment contracts, which in our view is too narrow. Our suggested edits to these definitions, and the other terms in Clause 4 noted above, are included in Appendix A.

Clause 8 – Price Path

- 15 Clause 8.3 has been changed and now includes a new description of the price path test, which is intended to limit Notional Revenue at any time during the Assessment Period to no more than the level of Allowable Notional Revenue. We find the proposed wording confusing and accordingly we do not believe it fulfils its objective. We include a simpler version in Appendix A.
- 16 Our submission on the 'revenue adjustment term' has not been accepted, and the Update Paper indicates this is to be considered further next year. We are disappointed at this decision and fail to understand the reasons for it. In addition, we believe it is an inappropriate outcome because EDBs will not, as a result, have sufficient information to understand the consequences of the pricing decisions they are making now. In addition, the resulting formula in the Draft Determination is not consistent with a price path and therefore inconsistent with the Draft Decisions.
- 17 We are surprised at the list of issues which the Commission suggests it needs to consider further before a "revenue adjustment term" can be developed. The issues listed in Appendix A, row 10, are issues which we understood had been, and we would have expected them to have been, considered by the Commission throughout the consultation on the DPP.
- 18 We understand that the Commission is concerned that at the time prices are set for the following year, the final t-1 Notional Revenue and Allowable Notional Revenue to be used in the adjustment term will not be known with certainty. The uncertainty will exist in respect of pass through costs, not prices or quantities, particularly now as t-2 quantities have been adopted for the purpose of the price path. At the time prices are set, the connection and

interconnection components of transmission will be known as will the other components of transmission charges unless a new New Investment Agreement comes into force within the last quarter of an Assessment Period (and this will be able to be predicted). In addition, monthly (or quarterly) charges will be known for Electricity Commission Levies and Commission Levies and Local Body Rates at this time for the remainder of t-1. We therefore do not accept the concern that this adjustment factor is not predictable. We submit that it should be included to ensure the price path formula is consistent with the Draft Decision and to provide certainty for EDBs when setting their prices for the forthcoming year.

- 19 Clause 8.5 of the Draft Determination requires Non-exempt EDBs which restructure their prices to provide certain evidence to the Commission. We support the amendments to this clause which have been made since the previous draft. We also submit that an additional clause, similar to Clause 5(5) in the Thresholds Notice is included to provide for instances where a Non-exempt EDB does not have the information available to meet the requirements of 8.5(a) and 11.1 (b)(iii). This is particularly important now that t-2 quantities are to be applied in the price path. We know of one Non-exempt EDB which restructured its prices this year (ie: at 1 April 2009) for which t-2 quantities (ie: 1 April 2008 – 31 March 2009) consistent with the new price structure are not available.
- 20 We support the change in decision resulting in t-2 quantities for the price path. We note the Update Paper refers to these as known audited quantities. Although they are known by the EDBs, they will not however have been audited prior to the Annual Compliance Statement audit.

Clause 10 – Mergers and Acquisitions

- 21 A number of amendments to Clause 10 have been made, which we support. As previously indicated however we believe the requirement for the Non-exempt EDB to demonstrate “to the satisfaction of the Commission”, as included in Clause 10.3 (b), is an unworkable and unnecessary standard.
- 22 We continue to be confused however as why the provisions for mergers and acquisitions between EDBs are treated differently as those between Transpower and an EDB. In particular Clause 10.2 appropriately sets out how the quality standards are to be adjusted and compliance assessed following a transaction with an EDB. However similar provisions relating to a transaction with Transpower are included in Clause 11 not Clause 10. Clause 11 is intended to prescribe the information that must be included in an Annual Compliance

Statement. Clause 11.1 (b) prescribes that the Compliance Statement must contain “*sufficient information to support the statement required by paragraph (a) including:*” and then follows in sub clauses (i) – (vii) with a list of information to be included. However Clause 11.1(b) (iv) does not contain a list of information to be included in the Annual Compliance Statement, instead it prescribes how the quality standards and assessments must be adjusted following a transfer of assets between Transpower and a Non-exempt EDB, similar to the 10.3 (b) provisions for transactions between EDBs.

- 23 Accordingly Clauses 11.1 (b) (iv) (b)-(c) need to be deleted from Clause 11 and similar provisions included in Clause 10 to ensure that the requirements for compliance are separate, and are stated within the body of the Determination prior to the list of information that must form part of an Annual Compliance Statement.

Schedule 4 – Form of Auditors Report

- 24 The revised audit report addresses our previous concerns regarding qualifications of audit opinions in respect of quality standards. The audit of the Compliance Statement falls within the scope of the New Zealand Institute of Chartered Accountants, Standard on Assurance Engagements 3100 Compliance Engagements (SAE 3100). This standard provides guidance as to the nature and extent of procedures to be undertaken by auditors to provide reasonable assurance that Annual Compliance Statements comply materially with the Determination. It also requires auditors to comply with ethical requirements. It will be useful to refer to SAE 3100 in the audit opinion to ensure consistency of approach by auditors. The audit opinion should therefore refer to SAE 3100 in the 'Auditors Responsibilities' subheading. In addition, the first paragraph under this subheading is inconsistent with the opinion paragraph and requires amendment.
- 25 In addition, and of most concern is the inappropriate limitations in respect of auditors independence. This is not consistent with the requirements recently consulted upon and agreed in respect of the 2008 Information Disclosure Requirements for EDBs, nor is it consistent with the definition of auditor contained in Clause 4 of the DPP, as follows:

Auditor, in relation to a Non-exempt EDB, means a person who:

- (a) is qualified for appointment as auditor of a company under the Companies Act 1993; and
- (b) has no relationship with, or interest in, the Non-exempt EDB that is likely to involve the Person in a conflict of interest; and

- (c) has not assisted with the preparation of the Annual Compliance Statement or provided advice or opinions (other than in relation to audit reports) on the methodologies or processes used in preparing the Annual Compliance Statement; and
- (d) has the necessary expertise to properly undertake an audit required by clause 11.1(c); but
- (e) need not be the same Person as the Person who audits the Non-exempt EDB's accounts for any other purpose

26 We expect it will be difficult for most auditors in New Zealand to meet the independence restrictions in the proposed form of audit opinion and therefore we believe it is unworkable. Guidance on independence issued by the Institute of Chartered Accountants in New Zealand is the most appropriate guidance to use. Our suggested revision included in Appendix A is consistent with the existing threshold provisions and those in the 2008 Information Disclosure Requirements.

The primary contact for this submission is:

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

Appendix A – Suggested Amendments to the DPP Determination

Clause 4 – Interpretation

Assessment Dataset means the set of daily SAIDI Values and SAIFI Values for an Assessment Period, with Interruptions that span multiple calendar days and all Interruptions attributable to the same event accrued to the day on which the Interruption began

Avoided Transmission Charge means

(a) any expense (including the cost of capital) of a Non-exempt EDB that arises during the Assessment Period from any activity which substitutes for the use of the Transmission System; and

(b) where Electricity Lines Services are transferred between Transpower and the Non-exempt EDB includes the value of the Transmission Charges avoided from the date of the transfer

Pass-Through Costs means:

(a) the Transmission Charges, Rates, Electricity Commission Levies and Commerce Act Levies, paid or payable by a Non-exempt EDB during an Assessment Period including the 2009/10 Commerce Act Levies pursuant to Clause 8.6;

but does not include:

(b) any amounts described in paragraph (a) if the Non-exempt EDB demonstrates ~~to the satisfaction of the Commission~~ that those amounts were passed on transparently to its Consumers and/or electricity retailers.

Reference Dataset means the set of daily SAIDI Values and SAIFI Values for the Reference Period, with Interruptions that span multiple calendar days and all Interruptions attributable to the same event accrued to the day on which the Interruption first began

Transmission charge, means any amount in respect of—

- (a) Electricity Lines Services provided to a Non-exempt EDB ~~by Transpower in respect of the Transmission Grid~~ in accordance with the Transmission Pricing Methodology; and
- (b) the provision of System Operator Services; and
- (c) new investment contracts ~~in respect of the Transmission Grid, as defined in Schedule F5 of Section IV of Part F of the Electricity Governance Rules 2003, between Transpower and a Non-exempt EDB;~~ and
- (d) Avoided Transmission Charges

Clause 8 – Price Path

8.3 Allowable Notional Revenue

~~Allowable Notional revenue (R_t) specifies the maximum Prices that may be charged during an Assessment Period, such that the notional revenue (NR_t) of a Non-exempt EDB at any time during the Assessment Period must not exceed the greater of the notional revenue at the Assessment Date and the allowable notional revenue for the Assessment Period, Notional Revenue at any time during the Assessment Period (NR_t) is not to exceed Allowable Notional Revenue (R_t), where:~~

$$\frac{NR_t}{R_t} \leq 1$$

where:

NR_t is the notional revenue for the Assessment Period t, being equal to:

$$\sum_i P_{i,t} Q_{i,t-2} - K_t$$

R_t is the allowable notional revenue for the Assessment Period t, being equal to:

Allowable Notional Revenue in the First Assessment Period:

$$R_t \equiv \left(\sum_i P_{i,t-1} Q_{i,t-2} - K_{t-1} \right) \times (1 + \Delta CPI_t) (1-X)$$

Allowable Notional Revenue in the Second and Subsequent Assessment Periods:

$$R_t \equiv \left(\sum_i P_{i,t-1} Q_{i,t-2} - K_{t-1} + R_{t-1} - NR_{t-1} \right) \times (1 + \Delta CPI_t) (1-X)$$

where:

[etc]

8.5 Restructuring of Prices

If a Non-exempt EDB restructures its prices that apply during an Assessment Period, it must demonstrate ~~to the satisfaction of the Commission~~ in its Annual Compliance Statement for that Assessment Period (with supporting evidence as set out in clause 11.1(b)(i)-(iii)) whether or not the restructuring of itself increased its allowable notional revenue for that Assessment Period above that which would have applied if the restructuring had not occurred, and -

(a) if the restructuring, of itself did not increase the Non-exempt EDB's allowable notional revenue for that Assessment Period, clause 8.3 will apply as if the new Price structure applied on and from the beginning of that Assessment Period; and

(b) if the restructuring of itself did increase the Non-exempt EDB's Allowable Notional revenue for the Assessment Period, the price path will not have been complied with.

Clause 10 – Mergers and Acquisitions

10.2 If a Non-exempt EDB completed a purchase, merger, takeover, disposal, or other similar transaction with either an EDB or Transpower in the preceding Assessment Period:

[etc]

10.3 If -

(a) ~~the Commission is satisfied that~~ because of a lack of information, where the deficiency is beyond the control of the Non-exempt EDB, it is not practicable to determine whether a Non-exempt EDB involved in a purchase, merger, takeover, disposal, or other similar transaction complied with the price-path and quality standards in an assessment period; and

(b) the Non-exempt EDB demonstrates ~~to the satisfaction of the Commission~~ by use of an alternative approach that has the equivalent effect of clauses 8 and 9, that the substance of those clauses has been complied with -

the Non-exempt EDB will be regarded as having complied with the default price-quality path during that Assessment Period.

Clause 11 – Compliance Assessments

11.1 (b) (iii) if the Non-exempt EDB restructured its Prices as referred to in clause 8.5,

(a) information of the kind set out in subparagraphs (i) and (ii) that demonstrates whether or not the Price restructure has of itself increased the Non-exempt EDB's allowable notional revenue using both the previous and restructured Prices and Quantities; but

(b) if because of a lack of information, it is not practicable to comply with subclause (a) the Non-exempt EDB may demonstrate by use of an alternative approach that has the equivalent effect, that clause 8.5(a) has been complied with

11.1 (b) (iv) if assets used for providing Electricity Lines Services were transferred from Transpower to the Non-exempt EDB: ~~(a) for the Assessment Period in which the transfer was completed, SAIDI and SAIFI statistics and calculations (including those in Schedule 3) that demonstrate whether or not the transfer increased the Non-exempt EDBs Assessed Values;~~

~~(b) for the Assessment Period that immediately follows the Assessment Period in which the transfer was completed, the Reliability Limits must be recalculated using the process outlined in Schedule 3, which must include the planned and unplanned interruptions by Transpower that are relevant to the assets transferred, as if the transfer occurred at the beginning of the Reference Period; and~~

~~(c) ; for the Assessment Period that immediately follows the Assessment Period in which the transfer was completed, the Assessed Values must be calculated using the process outlined in Schedule 3, which must include the planned and unplanned interruptions by Transpower that are relevant to the assets transferred, as if the transfer occurred at the beginning of the Assessment Period;~~

[Insert the following if suggested amendments to Pass Through Costs and Clause 10.3 are not adopted]

11.1 (e) For the avoidance of doubt the Annual Compliance Statement, Auditors Report and Directors Statement need not state whether the Commission is satisfied as to the matters referred to in Clause 4 and 10

Schedule 4 – Form of Auditors Reports

Auditor’s Responsibilities

My/our responsibility is to express an opinion on whether the Annual Compliance Statement complies with the Determination in all material respects ~~based on my/our audit~~. I/We conducted my/our audit in accordance with the New Zealand Institute of Chartered Accountants Standard on Assurance Engagements 3100 Compliance Engagements International Standards on Auditing (New Zealand). Those standards require that I/we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the Annual Compliance Statement ~~is free from material misstatement~~ has been prepared, in all material respects, in accordance with the Determination.

[etc]

~~Other than in my/our capacity as auditor~~ I/we have no relationship with, or interests in *[insert name of Non-exempt EDB]* other than [insert relationship and/or interests including a statement verifying that no conflict of interest exists].