

**Speech to the Electricity Network Association CEO's Meeting -
19 June 2008**

1. Thank you for inviting me to attend your Chief Executive's forum in Christchurch today. I will provide an update of where the Commission has got to with respect to the leading workstreams that impact on the ENA membership.
2. I will particularly focus on thresholds, the threshold reset and the work that the Commission is doing in order to ensure that we are able to establish revised thresholds within the timeframes that will enable these to take effect from 1 April 2009.
3. Firstly, thank you to all who enabled some of their valued technical and network experts to be freed up to support the information disclosure non-financial performance and specifications workshop, held yesterday. The timetable on the day was very ambitious but was achieved with the focus of everyone in the room. It is our intention that the outcomes from this workshop will form part of the exposure draft that will be released in July for consultation. Secondly, I wish to thank all member companies and other submitters here today for the submissions that they have provided to date in response to the Threshold Reset Discussion Paper. The submissions have been considered closely and a number of the matters raised by interested parties have given the Commission cause to conduct further research and analysis. The Commission in its June paper, that we intend releasing within the next week, will set out a number of preliminary views and indicated where it is considered that further analysis is required.
4. Our experiences over the past four years of the regime should clarify how the Commission views the existing regime and therefore how we consider the assessment and inquiry aspects of the thresholds **[First Slide]**. The Commission:

- Once it has set the thresholds for the five year period, would rather that these remained to provide certainty for the whole regulatory period, thereby providing incentives to invest and innovate and increasing the opportunity for efficiency to be developed, the benefits of which can be shared with consumers;
- Where there is a need for different thresholds that is clearly justified by a specific business – the process and mechanism to enable a threshold or thresholds to be revised – would provide a more effective outcome (*customised thresholds* are therefore discussed in more detail later);
- Where a reasonable administrative settlement can be reached, within a reasonable timeframe, and a Deed of Settlement signed with the relevant business; the Commission will be inclined to accept such a settlement provided that:
 - it is consistent with the Purpose Statement of Part 4A;
 - there are no other Purpose Statement (57E) concerns or that such concerns are being positively addressed; and
 - there is a clear commitment from the business concerned that they can operate within the terms of the settlement – particular the existing price and quality thresholds or any variant of those agreed as part of the settlement.

Threshold Reset - Adjusted Emphasis [Slide 2]

Snap Preview: The following discussion gives you a ‘snap preview’ of where the Commission’s thinking is currently. As I speak today, a Division Meeting is considering the issues I am going to discuss. Preliminary decisions by the Commission are yet to be confirmed. However, it can be expected that a number of the matters I referred to today will be contained, as I have described them, in an updating paper, which we will release shortly, as I noted above.

5. You will recall that the process the Commission had originally intended to follow was to release a Methodologies Paper that would include proposed options for the detailed form of thresholds and preliminary indications of the range of threshold levels likely for Electricity Lines Businesses to consider.
6. The Commission has decided that this will not be possible at this time and has therefore opted to adjust the emphasis and focus of the June paper to be a paper that, rather than consulting on the methodologies for the Reset, sets out the preliminary views that the Commission has formed; responses to submissions; and clearly highlights the areas where the Commission will conduct further research.

Initial Decisions Paper – September 2008

7. The Commission will now set out the detailed form of the thresholds and the preliminary indications on the range of threshold levels in its Initial Decisions Paper which will be released in September 2008.
8. A conference scheduled for October 2008 will continue as proposed and cross submissions with respect to the Initial Decisions Paper will be sought, following the conclusion of the conference.
9. It is intended to consult on indicative threshold levels in November 2008 and to publish the Final Decisions Paper in December 2008.

Overall Regulatory Framework [Slide 3]

11. The Commission considers it is appropriate to proceed with the reset with a view to having new arrangements in place from 1 April 2009. The existing arrangements were put in place to have effect from 1 April 2004

for a period of five years.

12. The Commission, having considered submissions, remains of the view that a five-year regulatory period is appropriate and is consistent with regulatory practice in overseas jurisdictions. It is the Commission's view that the five-year period strikes a reasonable balance between the interests of regulated businesses and the interests of consumers as five-year periods are, generally, sufficient to maintain incentives for firms to improve efficiency. The five-year period also enables regulators to bring prices back into line with costs in a timely manner where businesses exceed efficiency expectations.
13. An important consideration within the regime is also the sharing of efficiency gains with consumers. The Five-year period enables, where necessary, for such gains that have not already crystallized by way of more efficiency network operations and technical improvements, to be shared by consumers by way of lower prices, if this is considered appropriate by the regulator. In summary, five years is considered to be a reasonable period within which to review the effects and efforts of the regulatory mechanisms and the performance of the parties subject to those mechanisms.

Overall Form of the Thresholds

14. The Commission confirms that the overall regulatory framework will comprise of a price-path threshold, based on a *CPI-X* incentive mechanism and a quality threshold consisting of a single criterion focused on reliability.
15. It is the Commission's preliminary view that the Consumer Engagement criteria of the existing threshold will not continue as a threshold at the

reset but that information disclosure requirements will be developed to cover consumer engagement.

Section 57E Purpose Statement and the Efficient Operation of Lines Businesses

16. Productivity and Profitability are relevant to promote the aims of the Purpose Statement.
17. The Purpose Statement of the regime is set out at section 57E and may be broken down into three parts as set out by Wild J in the High Court.
 - (i) The statement of purpose; to promote the efficient operation of markets directly related to electricity distribution services.
 - (ii) The means of achieving that purpose; through targeted control for the long term benefit of consumers.
 - (iii) The amplification of that means, in the form of ensuring that the objectives set out in paragraphs (a) to (c) are achieved.¹
18. In addition under section 26 the Commission will have regard to Government economic policy that from time-to-time is transmitted in writing to the Commission by the Minister of Commerce. In this regard there are two Government Policy Statements (GPS) that are relevant – the August 2006 GPS on *Infrastructure Investment Incentives* and the May 2008 GPS on *Electricity Governance*. These have both been considered carefully.
19. There are three relevant dimensions of efficiency that the Commission carefully considers when making its regulatory decisions [**Slide 4**]:

¹ *Unison Networks Limited v The Commerce Commission & Powerco Limited*, Unreported, High Court (Wild J), Wellington, CIV 2004 485 960, 28 November 2005, paras [110] – [112].

- allocative efficiency – where a business prices its services to reflect the efficient costs of supplying those services, thereby earning normal returns (after allowing for the degree of risk involved);
- productive efficiency – where a business produces services at the desired quality at minimum cost; and
- dynamic efficiency – where a business has the appropriate incentives to invest, innovate and improve the range and quality of services, increase productivity, and lower costs over time.

Aggregate Productivity [Slide 5]

20. The Commission considers that a B-factor, based on aggregate productivity and calculated using Total Factor Productivity (“TFP”) analysis, should be retained in the new price-path threshold. The B-factor, as was noted in the Discussion Paper, does provide an important “check” as to how Electricity Lines Businesses are performing relative to the NZ economy as a whole by reflecting the growth in the sector’s TFP relative to economy-wide TFP.
21. There are a number of issues to be considered and resolved before the final TFP is calculated for the industry. For example the absence of a reliability measure was identified by submitters as an issue. The Commission will engage its experts to undertake further research to determine whether a measure or measures for reliability and security of supply can be included in the productivity measure. Incorporation of the most recent Information Disclosure data and understanding the trend data requires further analysis. Results of this analysis will be included in the Initial Decisions Paper.

Relative Productivity

22. It is the Commission’s preliminary view that a factor based on relative productivity encourages EDBs to move towards operating at the efficient frontier and promotes overall economic efficiency. The Commission

- acknowledges that further research and analysis is required to ensure the basis of the Multiple Total Factor Productivity (“MTFP”) analysis is sufficiently robust.
23. Many submissions to the Discussion Paper did not support the C1 factor due to data limitations and that the methodology used was hard to understand and appeared to be based on technical rather than economic efficiency.
 24. The Commission however considers the methodology employed for MTFP is very clearly explained and relatively easy to reproduce. Moreover it measures both technical and *allocative* efficiency by using value shares to weight both the output and input quantities used to derive the MTFP outcomes.
 25. The Commission notes the submissions made about the environmental differences between networks and the need to consider inclusion of a reliability measure for MTFP analysis. Further research will be conducted on these matters.

Profitability

26. The Commission received many submissions on the current relative profitability C2 factor and the alternative P0 adjustment using partial building blocks proposed in the Discussion Paper.
27. The Commission is of the view that a profitability adjustment of some form is required in order to ensure that lines businesses are limited from earning excess profits. Productivity alone would not do this.
28. A P0 adjustment based on partial building blocks and with sufficient, accurate information may still be an appropriate and likely more effective

approach than a relative profitability factor. If a P0 adjustment is to be used it would be directed to profitability levels only and not be directed to efficiency differences between lines businesses.

29. The Commission recognizes that further research is required before such a profitability adjustment could be undertaken and intends to do so with the outcomes of the analysis forming part of the Initial Decisions paper.

Network Investment [Slide 6]

30. The Commission recognizes that a number of lines businesses are facing increasing investment requirements in coming years, especially from 2014 onwards. However, the data received from lines businesses and the analysis of that data and the submissions to the December Discussion Paper do not reflect a situation where the industry, as a whole, faces a “wall of wire” as had been portrayed at times in the past.
31. A specific incentive factor for investment and innovation appears an appropriate mechanism to be introduced into the price-path. This was discussed in the December paper as an I-factor and the concept was supported by a number of submitters.
32. The Commission considers that an I-factor should not be introduced at the next reset but should be developed in readiness for 2014. In the meantime, where additional investment requirements beyond the price-path are considered necessary by a lines business, then the Commission proposes that these should be addressed by customised thresholds. It is proposed that this mechanism be developed and consulted upon in 2009 for implementation in 2010.

Accountability for Network Investment

33. Where customised thresholds are established that recognize specific additional investment requirements, then accountability should be built into the threshold. A number of very helpful submissions were provided that the Commission will consider and develop. It is intended that any consultation on accountability to underpin investment incentive provisions will be part of the consultative process on customised thresholds.

Service Quality [Slide 7]

34. The Commission remains of the view that a separate quality threshold is a requirement for the reset. If price only was constrained, reliability of supply could be adversely affected as the incentive would be to maximize profits by simply reducing costs. The objective of the two thresholds therefore is to provide an appropriate balance between price and quality.
35. The Commission agrees with submitters that the existing reliability mechanism requires improvements.
36. One of the Discussion paper proposals was to consider the establishment of peer groups to benchmark quality as a means of assessing relative performance of each business comparative to its peers. Many submitters considered that peer groups would be subjective and arbitrary.
37. The Commission acknowledges that each lines business has different network characteristics and that these must be accounted for but the differences are not so unique that individual lines businesses cannot be assigned to particular peer groups. We are seeking a reasonable assessment mechanism. The Commission will undertake further research and analysis as to how to categorise and establish peer groups. This will

be consulted on as part of the Initial Decisions Paper in September.

38. A primary aim must be to align network reliability at levels that consumers demand. Where a lines business's reliability differs markedly to that of identified peers, the Commission's preliminary view is that a further investigation would be warranted to ensure that the price/quality trade off is achieved. Further research will also be focused on this to ascertain how best the Commission can assess the levels of reliability that particular lines businesses should achieve.
39. An S-factor is another approach that the Commission could take to address the price-quality trade-offs. Before introducing this alternative, further research and analysis is intended including whether a proposed S-factor is an appropriate mechanism for incentivizing the price-quality trade-off.
40. The Commission is clear however that all lines businesses should have the incentive to continue to seek improvements in quality for the long-term benefit of consumers, aligned to consumer demands. It is unlikely that we will have sufficiently robust data in this regulatory period to be assured of this alignment. We intend to continue work, even after the review: both in terms of future mechanisms for thresholds and complementary Information Disclosure requirements.

Data Refinements for Reliability [Slide 8]

41. The Commission has a preliminary view that it will introduce three data refinements for the quality threshold:
 - Use of the Beta Method for normalizing reliability data for extreme events;

- The employment of three-year moving averages to address normal variability of data; and
 - Separate quality thresholds for non-contiguous networks and networks with ownership/beneficiary differences.
42. The Commission intends to adopt the three refinements when undertaking further research on underlying reliability performance. These matters too will be further consulted on in September 2008.

Service Quality Criteria

43. A number of overseas regimes employ a range of service quality criteria as components of quality regulation including:
- Average time to respond to customer problems;
 - Guaranteed service levels; and
 - Annual numbers of service complaints received and resolved.
44. The Commission as part of its research and analysis will further consider the merits of introducing service quality incentives either into the thresholds or, as some parties have suggested, as part of Information Disclosure Requirements, before setting out its initial views in September 2008.
45. A guaranteed service level scheme is not proposed for the 2009 reset.

Refinements to the Thresholds [Slide 9]

46. In the December 2007 Discussion Paper, the Commission outlined a number of areas where refinements to the existing thresholds and/or complementary Information Disclosure may be introduced. These

refinements stemmed from international regulatory practice; industry comment and feedback over time; and the experiences that the Commission has gathered when operating the thresholds.

47. *Excluded Services* - These are services not taken into account when assessing compliance with the price-path threshold. Having considered the *excluded services* definition, the Commission in its draft recommended no changes.
48. The majority of submitters supported the existing definition and the list of excluded services. There was support from some submitters for a redefinition of tightening of the “specified services” definition, rather than any changes to *excluded services*. We agree with the notion that the definition of *specified services* should be clear and unambiguous. This however must be balanced with the need to allow for flexibility when determining the services subject to regulation – particularly as these services change over time. The way the definition is drafted should enable consideration of whether any new service should be excluded or specified.
49. The Commission does not intend to consult further on these definitions.
50. *Pass-through costs* – These are defined as operating costs for which the lines businesses have no control (they are exogenously determined and cannot be avoided by the lines businesses).
51. The existing categories of pass-through are local authority rates; electricity commission levies; transmission charges and avoided transmission charges.
52. In the Discussion Paper we proposed passing through rates and levies. We were not so inclined to continue the current treatment for pass-through

- of transmission charges and avoided transmission charges. The Commission referenced previous consultation and noted that an identified solution was to unbundle transmission revenues and Transmission charges from the price-path formula, which could be brought forward as part of the reset.
53. A key element in some submissions has focused on the incentive and disincentive effects of simply passing through transmission charges and avoided charges. It was noted specifically that this effectively eliminated incentives to reduce peak load and thereby may have upstream perversity – in the sense that it provided no transmission investment deferrals.
 54. It is noted that Orion actively manage this issue now by considering carefully what network investments they want to make with a view to optimizing their network, including managing transmission charges as a result.
 55. There can be management of transmission charges and therefore management of the charges passed-through to consumers, by the investments that lines businesses make. Moreover, it is likely that there will be resultant beneficial effects in load management.
 56. I particularly want to commend the positive ENA submission on this point that I know many contributed to. That indicated an approach to providing stronger incentives to manage transmission peaks.
 57. Pass-through volumes were also an issue raised particularly by Orion.
 58. There is the potential to promote energy efficiency and there are incentive effects relating to the treatment of transmission charges and avoided transmission charges that the Commission does wish to consider further.

There are a number of issues that must be dealt with, if the Commission were to unbundle transmission revenues and Transpower's charges from the price-path formula. The Commission will conduct further research and analysis.

59. *Assessment and Inquiry Guidelines* – These will be reviewed and updated in early 2009 to take effect no later than September/October 2009. The improvements identified by a number of submitters will be taken into account. Such Guidelines will be required whether or not the Bill comes into force, although, in the latter case, they may be dealt with as part of the *Regulatory Specifications* identified by the Bill. I note a similar suggestion by ENA and other lines businesses vis a commitment to doing such a thing in the context of the RPG process paper consultative process.
60. One specific area of review of the guidelines will be to improve the *predictability of the threshold assessment and inquiry process*. The Commission has been working on this for some time, particularly focused on issues such as the materiality of breaches; the identification and treatment of “technical breaches” and indicative timetables for post breach inquiries.
61. *Customised Thresholds* – We have been developing our thinking for some time and discussing concepts such as customised thresholds with some interested parties informally over the past two - to - three years, as all of our experience of the post-breach inquiries and administrative settlement processes have developed. The Commission recognized the diverse nature and characteristics of the 29 Lines Businesses and that by design there is a generic element to the thresholds. To complement the thresholds, the Commission proposes establishing a process of *customised thresholds* that will account for exceptional investment needs

- resulting from the specific characteristics and circumstances of individual lines businesses, at those businesses' initiative. This may include proposals to incentivise distributed generation.
62. The Commission notes support for this approach from the majority of submitters and proposes to develop and then consult on *customised thresholds* in early-2009.
 63. *Energy Efficiency, Load Management and Distributed Generation* – While retailers may have the greatest immediate scope for promoting energy efficiency, the Commission considers that there are still matters that can be addressed specifically by Lines Businesses that will likely promote energy efficiency; load management; and reducing transmission peaks.
 64. There is scope for further consideration of the development of incentives for energy efficiency within the thresholds and for considering enhanced information disclosure requirements; the latter particularly detailing system losses by time and area.

Conclusions

65. An Update paper covering all these matters will be released before the end of the Month. Today I have presented a snap preview only of our thinking.
66. We will also be seeking further information from lines businesses – particularly an update on some of the key reliability data, previously sought. This will relate to the most recent 2007/08 year; and historic cost data spanning the current regulatory period; Most recently we have been examining the 2007 OPEX/CAPEX data. There are a number of companies with considerable OPEX/CAPEX increases year-on-year.

These are not immediately explained by the Companies from the disclosures. We will be seeking further information from the relevant Companies on the reasons for the increases.

67. The Commission has recently released significant decisions with respect to the Transpower and Vector post-breach inquiries – What is most interesting about the former is the fact that we will be setting three new thresholds to cover quality; Electricity Commission approved investments; and, what Transpower describe, as non-part F investments. The outcomes have enabled greater certainty for Transpower and their investment incentives, whilst also significantly dealing with the efficiency of Transpower's Prices - \$240 million being a conservative assessment of the savings achieved for consumers over the relevant period.
68. In Vector's case we are assured that the price rebalancing undertaken better reflects underlying costs, demand and service quality for Vector's consumers. The settlement received a favourable market reaction.
69. In each case these were proposals agreed to and made by the businesses, consistent with the 57E Purpose Statement.
70. Decisions not to Declare Control – 06/06/08. 15 businesses and 29 specific price and/or quality breaches recently were determined to not be matters that the Commission would pursue further. We continue to press on to deal with outstanding matters in priority order. We listen carefully to what businesses say about certainty and timeliness – the regime has achieved a lot, in a short space of time compared with the commencement of regulatory regimes offshore – there are still things we can do to improve the regime further.

71. We have received your submissions on the *Regulatory Principles and Guidelines* process paper and will be considering your submissions closely.

72. Whether we have changes of legislation or remain to develop the existing Part 4A regime further – I and the Chair are committed to continuing this progress. I have a fabulous and committed staff with very good and developing technical expertise. I intend to do everything to keep their jobs interesting and to expand our capacity and capability further. I look forward to further interaction on the multitude of matters we are and will be dealing with you all.

73. Thank you all for your time today.