

AUCKLAND ENERGY CONSUMER TRUST

SUBMISSION TO COMMERCE COMMISSION

ON THE

2010 RESET OF THE DEFAULT PRICE-QUALITY PATH

12 October 2009

AECT SUBMISSION ON THE DRAFT DECISIONS PAPER PUBLISHED BY THE COMMERCE COMMISSION ON THE RESET OF THE DEFAULT PRICE-QUALITY PATH FOR ELECTRICITY DISTRIBUTION BUSINESSES

1 Introduction

- The Commerce Commission (Commission) has published a Draft Decisions Paper¹ setting out its preliminary views on the proposed content and form of the Default Price-quality Path (DPP) which is to take effect from 1 April 2010. The DPP is to apply to Electricity Distribution Businesses (EDBs) that are not exempt (i.e. small consumer-owned EDBs are exempt).
- The Auckland Energy Consumer Trust (AECT) broadly agrees with the Commission's proposals as outlined in the Draft Decision Paper. Appendix 1 provides a summary of the key draft decisions that the AECT supports.
- As such, this submission focuses on the key issues that arise from the Commission's reset decision, identifies the specific concern for the AECT, and makes recommendations to address these concerns.
- Section 2 of this submission provides a summary of the issues and recommendations. In Sections 3 to 6 each of the separate issues is discussed in greater detail.

2 Summary of Submission – Issues and Recommendations

- Before raising specific issues concerning the Draft Decision Paper, the AECT would like to raise a general concern with the process surrounding both the input methodologies and the setting of the default price path. While we acknowledge that the Commission inherited a difficult task in transitioning from the former threshold regime to a new DPP regime as a consequence of the Commerce Amendment Act 2008, it is clear with the benefit of hindsight that a more efficient process could have been followed. As it currently stands, the input methodologies will not be finalised until late in 2010, well after the 1 December 2009 deadline for setting the DPP parameters. On the evidence available, a large amount of work will remain incomplete and will require resolution before the 2015 reset. In addition, policy initiatives arising from the Ministerial Review of the Electricity Industry will also increase regulatory workloads for both the Commission and regulated EDBs. Accordingly, the

¹ Commerce Commission; "Initial Reset of Default Price-Quality Path for Electricity Distribution Businesses: Draft Decisions Paper"; 8 September 2009.

AECT would recommend that the Commission convene a conference early in 2010 to set a regulatory timetable and agenda for period leading up to the 2015 reset.

➤ From the AECT's perspective as an investor, the key issues arising from the Draft Decision Paper are the:

- P_0 Adjustment
- X-factor
- Incentive mechanisms
- Pass Through of Regulatory Costs

➤ In respect of these issues, AECT's concerns and recommendations are as follows:

- i. **P_0 Adjustment** – the Commission has determined that a final decision on any P_0 adjustment will be deferred – in large part because it requires clarification of the input methodologies. However, any P_0 adjustment will have material cash-flow implications and therefore judgement on the appropriateness of the proposed DPP arrangements has to be reserved until the P_0 adjustment (if any) is specified.

AECT recommends that the Commission undertake an analysis of the requirement for starting price adjustments once input methodologies are finalised. In addition, when giving effect to P_0 adjustments (if any are required), the Commission should avoid clawbacks in all but exceptional circumstances.

- ii. **X-factor** – the AECT is comfortable with the proposed $X = 0$. However, it is not clear what method the Commission has used to determine the X-factor. It is apparent that the Commission has not settled on either the Commission's advisor's approach or an alternative endorsed by ENA. Having certainty on the approach to setting the X-factor is important as understanding the methodology allows EDB management to test business decisions aimed at improving productivity against the methodology over the five year reset period and ahead of the next reset in five years time.

AECT recommends that the Commission support the productivity methodology endorsed by the ENA.

- iii. **Incentive mechanisms** – Price Path (i.e. $CPI - X$) regulatory regimes are considered to have an inherent incentive arrangement built in. However, several potential areas for introducing incentives are yet to be addressed and the incentive carryover mechanism also requires

specification.

AECT recommends that the Commission convene a conference early in 2010 to set a regulatory timetable and agenda for the development of incentive arrangements to apply from the commencement of the 2015 reset or such earlier date as the Commission determines is appropriate.

- iv. **Pass Through of Regulatory Costs** – One key tenet of any successful regulatory regime must be that regulated firms are able to recover reasonably incurred costs associated with participation in the regulatory process. At present, EDBs are incurring considerable regulatory costs and are likely to face further significant costs, including regulatory costs in relation to the Ministerial Review of the electricity sector currently underway. To allow EDBs to efficiently participate in the regulatory process,

AECT recommends that the Commission allow the costs associated with regulatory processes to be treated as pass-through costs.

3 P₀ Adjustment

- The Commission has determined that:

“...any potential adjustment to starting prices should take place after the determination of input methodologies. Further to this, the Commission’s view is that the deferred starting price adjustment should, if feasible, be implemented to take effect from 1 April 2011 to align with the 2011/12 pricing year.”²

- While such an approach is pragmatic and reflects the constraints facing the Commission, it does create considerable regulatory uncertainty for EDBs.
- Of particular concern is the risk with respect to immediate and future cash-flows. As it currently stands, final input methodologies are unlikely to be in place by late June (now more likely to be December 2009). This assumes that EDBs do not challenge aspects of the input methodologies resulting in a further uncertainty and extending the implementation process.
- With these potential delays, firms have considerable uncertainty with respect to future cash-flows. This is problematic in this time of economic uncertainty with cash forecasting a significant exercise for most firms given the difficulties they may have in accessing funding and the considerable capital expenditure programs many are undertaking.

² Supra, note 1, para 5.33.

- Obviously, uncertainty around cash-flows and by extension dividend payments places trust organisations such as the AECT in an awkward position. The AECT has implemented a policy of attempting to maintain stable distributions to income beneficiaries and to do this requires stability of dividend payments which could be placed at risk by the approach to the adjustments to starting prices – and in particular the imposition of any clawback. The Commission has discretion on this occasion not to impose a clawback. The AECT believes that clawbacks should only occur in exceptional circumstances, and in this regard, a delay in the determination of input methodologies would not constitute an exceptional circumstance.
- A further concern with P_0 adjustments relates to the conditions that would give rise to a downward adjustment to starting prices. The Commission indicates that such adjustments may be required:

“...in cases where EDBs are considered to be earning, or likely to earn, excessive profits and/or to promote the sharing of efficiency gains with consumers.”³

However, the Commission however goes further and comments that:

“Upward adjustments may be justified where past prices have been too low to allow a business to earn a normal rate of return. Dynamic efficiency is likely to be promoted through the potential for upward price adjustments which facilitate efficient investment and innovation.”⁴

- As an investor, the AECT has an expectation that Vector will earn superior returns through innovation and superior performance. Rather than seeking to clawback such returns, we believe that all EDBs should be provided with incentives to improve future profitability without increasing prices – and to (ultimately) share this with consumers. As a regulator, this requires the Commission to separate its roles as economic regulator from that its role as competition regulator. Only in the event that, acting in its role as competition regulator, the Commission anticipates a problem should it seek to clawback “excessive” profits through P_0 adjustments.
- AECT notes that the need for any P_0 adjustment will be a consequence of the input methodology process currently underway. The AECT will continue to provide its views to the Commission to help ensure that outcomes consistent with workable competition are promoted.

³ Supra note 1, paragraph 5.13

⁴ Supra note 1, paragraph 5.13

AECT Recommendations:

- Once input methodologies are finalised, an analysis of the requirement for starting price adjustments needs to be undertaken
- When giving effect to P_0 adjustments (if any are required), the Commission should avoid clawbacks in all but exceptional circumstances.

4 X-factor

- Once again the AECT supports what appears to be a pragmatic decision by the Commission to propose that the X-factor for the reset period will equal zero. Notwithstanding this pragmatism, we have a concern with the potential reliance on TFP analysis by the Commission in reaching its decision. In particular we are concerned with the comment at paragraph 6.8 of the Draft Decision Paper on the form of the productivity analysis where it is claimed that:

“Regulators in a number of jurisdictions (including Australia, the US, the UK and Canada) use TFP analysis to inform their decisions on appropriate levels for X-factors used under CPI-X price control regimes.”

- In their recent decision on the BC Hydro and Power Authorities revenue requirement application the British Columbia Utilities Commission made the following comment on TFP:

“With respect to BC Hydro's use of TFP as a performance indicator, the Commission Panel finds that while TFP may be useful to BC Hydro as an internal management tool, it adds little value to the revenue requirement review process given its macro level approach and because other Canadian utilities do not appear to have embraced the TFP.”⁵

- While the AECT supports the Commission using TFP to inform their decision in setting the X-factor, we would caution placing undue reliance on it.

⁵ British Columbia Utilities Commission, Decision BC Hydro 2009-F2010 Revenue Requirements, 13 March 2009. http://www.bcuc.com/Documents/Decisions/2009/DOC_21287_BCH-2009RR_WEB.pdf

- A further concern with the process for setting the X- factor is the lack of clarity regarding the method used by the Commission to determine the X-factor. It is apparent that the Commission has not settled on either the Commission’s advisor’s approach or an alternative endorsed by ENA. Having certainty on the approach to setting the X-factor is important as understanding the methodology allows EDB management to test business decisions aimed at improving productivity against the methodology.

AECT Recommendation:

- The Commission should support the productivity methodology endorsed by the ENA as, being easier to understand than the approach endorsed by the Commission’s advisors, it adds greater value to EDB decision making processes.

5 Incentive mechanisms

- Paragraph 3.6 of the Draft Decision Paper talks about investment incentives but the discussion is really about an incentive to invest in current technology. Clearly there is also a requirement to provide incentives for EDBs to invest in innovative technologies. The AECT would submit that relative to retailers who are not subject to regulation, but may be operating in a market environment where workable competition may not exist, EDBs are at a severe disadvantage. The retail sector is currently free to invest in new technologies unfettered by regulation – creating an uneven playing field that may discourage innovation by lines businesses.
- One area where there is potential for the early adoption of incentives is with respect to energy efficiency. There are a range of simple incentive mechanisms that can be applied to encourage EDBs to invest in energy efficiency initiatives in the short term, which don’t impact on the Commission’s ability to implement more robust incentive mechanism at some time in the future. However, innovation in the industry is being stymied by a desire to develop and implement a “perfect” incentive scheme from day one. The AECT would submit that it is far more important to implement a scheme that can evolve over time and get innovative energy efficiency initiatives underway sooner rather than later. There is no perfect regulatory arrangement, rather they all evolve over time in response
- The Commission has indicated that it will be working with interested parties to develop a potential S-Factor mechanism for implementation at the next

reset (2015).⁶ Rather than introducing an S-Factor at the commencement of the next reset period, the AECT support the implementation of an S-Factor at the earliest possible opportunity. We believe that this should be before the commencement of the next reset period, with the S-Factor scheme running in parallel with the currently proposed quality standards for the reset DPP. Those parties wishing to, should then be given the option of opting into the scheme ahead of the next reset.

- As the AECT noted in our earlier submission on the DPP discussion paper, any consideration of incentive arrangements must also include consideration of the efficiency carryover mechanism. While it is currently unclear how incentives to improve efficiency will be shared, the AECT is encouraged that the Commission based on the focus on this issue the commission to develop input methodologies that address this. It appears that there is no medium to long term benefit to regulated entities, as benefits can only be retained during the regulatory period.

AECT Recommendation:

- AECT recommends that the Commission convene a conference early in 2010 to set a regulatory timetable and agenda for the development of incentive arrangements to apply from the commencement of the 2015 reset or such earlier date as the Commission determines is appropriate..

6 Pass Through of Regulatory Costs

- The AECT notes that in reaching its decision on the DPP, the Commission has allowed certain costs to be treated as pass-through costs. However, it is noticeable that the costs of participating in the regulatory process are not specified as pass-through costs.
- One key tenet of any successful regulatory regime must be that regulated firms are able to recover reasonably incurred costs associated with participation in the regulatory process. At present, EDBs are incurring considerable regulatory costs and are likely to face further significant costs, including regulatory costs in relation to the Ministerial Review of the electricity sector currently underway. To allow EDBs to efficiently participate in the regulatory process, costs associated with the various regulatory processes should be treated as a cost pass-through.

⁶ Supra Note 1, paragraph 3.60

- In support of this position the AECT would note that the EDBs subject to regulation have little ability to control the costs associated with participation in the regulation process as these are largely a function of the regulatory agenda and timetable both of which are set by the Commission. As a consequence, allowing regulatory costs to be treated as a pass-through places an incentive on the Commission to ensure that the regulatory process is as efficient as possible – achieving the Commission’s implementation principle of cost-effectiveness.
- While there is a possible down-side in this approach, notably that there is no mechanism for control over regulatory costs, AECT would submit that simple mechanisms could be developed such as ex-post prudency reviews of regulatory compliance costs.

AECT Recommendation:

- The Commission should allow the costs associated with regulatory processes to be treated as pass-through costs.

Appendix 1 – Key Decisions Supported by AECT

AECT is supportive of the approach the Commission proposes to take with respect to the following matters:

- **Consistency with the legislative provisions relating to the DPP**
 - The Commission appears to have had regard to the regulatory framework requirement to provide low-cost reset of the DPP.

- **Flexible pricing methodologies**
 - Given the wide variation in the size, geographic location, customer mix and other similar variables faced by EDBs, the AECT supports the Commission’s decision to allow flexibility in determining the pricing methodology to be applied.
 - While variations in EDB pricing may complicate matters for electricity retailers, the benefits of flexibility in terms of allowing EDBs to accurately send signals to their customers through pricing arrangements will likely on balance far exceed any costs that might be incurred by retailers.

- **Quality Measures**
 - Subject to the general concern with performance incentives outlined in this submission, AECT supports the Commission’s use of SAIDI and SAIFI reliability measures as reflecting quality within the control of EDBs and the use of dead-bands and multiyear assessments.