



**Reset of Default Price-Quality Path for  
Electricity Distribution Businesses,  
Discussion Paper**

**17 July 2009**

## Executive summary

1. Powerco generally welcomes the Commission's approach to the DPP reset and appreciates the Commission's efforts to respond to the issues we have previously raised. In this submission Powerco discusses a number of concerns for the Commission to address in the next stage of the DPP's development.
2. Firstly, Powerco agrees with the Commission that the DPP reset must be driven by the regulatory purpose statement in Part 4. However, the Commission's considerations of how to balance the outcomes set out section 52(1)(a)-(d) of the purpose statement should not distract it from its central task - promotion of outcomes that are consistent with those produced in (workably) competitive markets.
3. A key part of this is promoting innovation and incentives to improve efficiency. If the Commission provides strong incentives, it could drive a step change in productivity and lower electricity prices in New Zealand. Powerco suggests two ways for the Commission to improve incentives in this submission.
4. In addition, a driver for the Commerce Act's reform was the need for certainty. This can be improved by simple and specific tangible rules, allowing firms to understand the impact on their business and parties to focus on areas of material disagreement. We look forward to receiving these specifics in early September. Face to face discussion is also an important part of robust debate and Powerco expects the Commission to hold a workshop or conference in the coming months to facilitate this.
5. The Commission does not need to overly complicate the DPP reset at this stage. For example, Powerco is comfortable with the Commission excluding quality and energy efficiency incentives (although we believe these are important parts of the regime and should be introduced before the 2016 reset). The Commission will have to apply judgement in some cases, and this submission indicates a number of reasons why the Commission should take a prudent approach when setting the generic X factor and adjusting starting prices.
6. Powerco provides some initial comments on total factor productivity, but will provide a supplementary submission by 31 July 2009 with more detailed comments on the reports provided by Economic Insights.
7. In addition, we support many of the Commission's proposals with respect to starting price adjustments, although we believe that the mid-point band should be at the 90 per cent confidence limit for the WACC and that lower end of the band should sit above the 50 percentile estimate. Thank you for considering the points raised in this submission.

## Introductory comments

8. Powerco welcomes the opportunity to comment on the Commerce Commission's 19 June 2009 discussion paper *Reset of Default Price-Quality Path for Electricity Distribution Businesses*.
9. The Default Price Path reset will be the first determination by the Commission under the new Part 4 of the Commerce Act 1986. Powerco generally welcomes the Commission's approach to the reset and supports the Commission's decisions in a number of areas. However, there are some preliminary issues which we consider must be addressed.

### *Need to focus on the workable competition standard*

10. The Commission, at page 8 of the Discussion Paper, rightly identifies the central purpose of the new Part 4 as the promotion of the long-term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition. It is also correct that the means of achieving that purpose is the promotion of outcomes that are consistent with those produced in (workably) competitive markets.
11. However, the Commission refers at several stages throughout the Discussion Paper to the need for it to balance the "regulatory objectives" in section 52A(1)(a)-(d). For example, it discusses the economic principles that it proposes to apply to assist it in balancing the "objectives" in (a)-(d) of the purpose statement.
12. The Commission should not let considerations of how to balance the outcomes set out section 52(1)(a)-(d) distract it from its central task. When resetting the DPP, the Commission's primary question should be whether its decisions are consistent with outcomes produced in workably competitive markets. If the Commission achieves this objective, the outcomes in (a)-(d) will have been met.
13. As such, the passage the Commission quotes, at paragraph 29, from the Select Committee Report on the Commerce Amendment Bill, should not be interpreted as enabling the Commission to balance the outcomes set out in (a)-(d) of the purpose statement as a substitute for promoting workably competitive outcomes. A balancing exercise of this nature is not the primary task set for the Commission by way of section 52.
14. One area where the most important consideration is the objective of promoting an outcome consistent with workable competition, is the setting of the initial regulatory asset base (RAB). The workable competition criterion leads inexorably to the use of ODV (or, rather, not lower than ODV) as the starting value for the RAB. In relation to the specific DPP Discussion Paper, observing the outcome of workably competitive markets leads to the conclusion that firms

should receive a reward for efficiency initiatives and innovation that is sufficient to motivate the behaviour of real-life firms.

*Simple, specific rules rather than detail and complexity*

15. The plea for businesses throughout the reform process, and in response to the Commission's consultation to date, has been for upfront certainty as to the rules that will be applied. What Powerco is seeking by way of upfront certainty is a set of specific and simple rules that provide us with a reasonable degree of confidence as to the outcomes those rules will produce for our business.
16. The certainty that businesses are asking for, and that the new regime requires, does not necessarily have to translate to the development of detailed and complex rules. Upfront certainty can instead be delivered through specificity and simplicity. The major change to the regulatory model intended by the reforms will be achieved if the regime delivers specific, simple rules.
17. For example, Powerco questions the merit of the Commission seeking to reinvent the theory of price cap regulation and the measurement of total factor productivity in the context of determining the DPP when tried and true methods (albeit, which may be approximations) exist. This is all the more so when the proposals were not accompanied with any demonstration of materiality, and when the work apparently has come at the expense of developing enduring arrangements for service and cost-efficiency incentives.
18. The Commission's paper also considers promoting incentives for energy efficiency and for improving quality. Powerco agrees with the Commission that it is not possible to develop these mechanisms and undertake adequate consultation by 1 December 2009. The Commission's previous experience in setting the *Commerce Act (Electricity Distribution Threshold) Notice 2004* and the *Commerce Act (Powerco Natural Gas Services) Authorisation 2008* indicates that unexpected problems may arise with formulas and definitions once they are applied by suppliers. Keeping the re-set simple is one way to reduce this risk. (A second way is ensuring suppliers to have adequate time to comment on the draft determination before it is finalised.)

*Proper consultation requires proposals of substance*

19. In response to the Commission's December 2008 discussion paper on the new Part 4, Powerco and other businesses signalled the need for the Commission to produce proposals of substance that would allow firms to begin focussing on, and to respond to during the Commission's consultation process.
20. While Powerco acknowledges that the Commission has produced some preliminary views in its Discussion Paper, and plans to release a draft determination later in the year, the paper is still lacking the level of substance

that firms need to begin considering and responding to, given the tight timeframes the Commission faces.

21. Both regulated firms and the Commission would benefit from the Commission moving away from preliminary theoretical discussions and putting up some rules which allow firms to see which of the issues are going to affect their business plans and revenues.
22. Businesses would then be able to signal the areas where they agree with the Commission's proposal, allowing all parties to focus on areas of disagreement. It would also allow businesses and the Commission to focus on areas where the disagreement has a material impact in practice, and spend less time on issues of theoretical interest but low practical impact. In Powerco's view, this would make for far more meaningful and effective consultation by the Commission. We look forward to receiving tangible proposals in early September.

#### *Consultation on technical issues*

23. As noted above, Powerco supports a number of the Commission's proposals. For example, Powerco agrees with a "no material deterioration standard" for setting the quality path. The remaining discussion is a technical one of how this should be measured. This is one of a number of technical discussions associated with finalising the DPP – the others being total factor productivity (TFP) and calculating the starting price adjustment.
24. The technical debate raises an issue with the consultative approach and timeline proposed by the Commission. Powerco appreciates that the Commission has a tight deadline, but asks that the Commission acknowledges the value of allowing experts to debate issues face to face. Ideally, the Commission would hold a technical workshop in the next few months to allow advisors to the Commission, ENA and suppliers to debate the various approaches to quality, TFP and starting price adjustments.
25. In addition, theoretical approaches cannot be assessed in a vacuum. They need to be applied to industry data and the appropriateness of the final output can be considered. In line with our comments above on the need to begin receiving substantive proposals, it is vital that the Commission applies technical or theoretical approaches to industry and supplier data as soon as possible. This will allow businesses to understand the impact of the theory on their operations. A technical workshop should be followed by a conference allowing industry participants to discuss the extent to which the DPP proposals meet the Part 4 purpose statement. Powerco also appreciates the Commission's recent signal that it will permit its own experts to be open to questioning at technical workshops or conferences in the future, rather than just the experts advanced by the EDBs.

## Nature and form

26. Powerco is broadly comfortable with the Commission's approach to re-setting the DPP and we support a number of the Commission's preliminary decisions. The timetable to publish a single draft determination in September is appropriate, although Powerco reiterates its recommendation that the Commission holds a technical workshop and conference on the DPP before the reset is determined in final form.
27. Powerco believes that energy efficiency and quality incentives should be part of the DPP mechanism, and this should be developed before the next regulatory reset in 2016. Powerco is comfortable with the Commission introducing an S factor scheme and energy efficiency rules in the middle of the regulatory period if the Commission's intentions to do this are stated at the beginning of the period and the schemes are voluntary.
28. Powerco also agrees that ideally the transmission cost "anomaly" should be addressed. At this stage, Powerco does not consider that transmission and distribution need to be unbundled in the DPP. Transmission costs (including avoided transmission costs) should be treated as a direct pass-through cost, with the quantity adjustment in the specification of the DPP providing a simple solution to the volume anomaly. Further incentives for managing transmission costs can be explored and included at a later date along with energy efficiency incentives.

## Incentives for efficiency

29. Powerco welcomes the Commission's emphasis in the principles section of the Discussion Paper on the need for distributors to be provided with incentives to act in socially beneficial ways, for example by pursuing cost reductions and providing the level of service quality desired by customers. Powerco is concerned, however, that some of the language in the Commission's discussion of this matter suggests that it envisages a limited or forensic approach to incentives that may risk the achievement of the socially beneficial outcomes that are intended. For example, the Commission's reference to the need to reward only 'genuine' innovations<sup>1</sup> suggests that the Commission may employ a forensic approach to weed out gains that are considered non-genuine. Similarly, the Commission's observation that companies in workably competitive markets will be rewarded for 'superior performance'<sup>2</sup> suggests a process of assessing whether a distributor's performance is superior to its peers, which is a line of inquiry that was central to the thresholds regime but is precluded under the new regime. Its suggestion that efficiency gains may only be retained for a 'short'

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<sup>1</sup> Commerce Commission, Reset of Default Price-Quality Path for Electricity Distribution Businesses, Discussion Paper, 19 June 2009, paragraph 57.

<sup>2</sup> Ibid., paragraph 41.

period of time<sup>3</sup> likewise may suggest the Commission envisages a limited role for financial incentives.

30. The central purpose of incentive regulation is to encourage distributors to improve their own performance, and hence to provide scope for future price reductions. Accordingly, the benchmark for whether a reward should be received is if the business has improved relative to what previously was the case. In addition, regarding the size of the benefit that is retained by the firm, clearly the share that the business retains needs to be sufficiently large to motivate the relevant initiative – without the businesses retaining a sufficient share of the benefits, the potential gains to customers will fail to materialise. The standard retention period for efficiency gains in Australia is five years (matched to coincide with the standard length of regulatory periods) which could be used as a guide, albeit at the lower end of the spectrum of incentives that should be seen as appropriate (and that may not be sufficient to motivate some worthwhile initiatives).
31. The DPP reset is an opportunity for the Commission to send a clear and simple signal to EDBs that they can take steps to innovate and become more dynamically efficient as there will be clarity on the treatment of abnormal profits. EDBs accept that the Act requires all efficiency gains to ultimately be shared with consumers. If the Commission provides strong incentives it could drive a step change in productivity and lower electricity prices in the long run.
32. A 3-5 year regulatory period means that the benefits would only be retained by the business for an average period of 1.5 to 2.5 years (and with virtually no incentive to make efficiency gains at the end of the period). Accordingly, distributors will need to be provided with a share of the benefits beyond the DPP redetermination if meaningful incentives for distributors to explore new efficiency initiatives are going to be created.
33. As the Commission has to give notice of the DPP reset by 1 December 2009, Powerco recognises there is limited scope for the design and implementation of a complete mechanism for providing such incentives. However, it would be a positive step for the Commission to commit to two interim measures for the purposes of the current review.
34. First, the Commission proposes to assess the current and projected profitability against an allowed band of returns, which would have the practical effect of permitting distributors to retain some of the gains from efficiency initiatives. If the Commission commits to again assessing returns against a similar band when reviewing the DPPs then an incentive for some efficiency initiatives will continue into the next regulatory period.

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<sup>3</sup> Ibid., paragraph 41.

35. Secondly, it would be appropriate for the Commission to assess specific initiatives that the businesses have undertaken and to permit the businesses to retain a reasonable share of the net benefit that is created into the next regulatory period. Again, incentives for businesses to continue to pursue efficiency gains in the period ahead will require a commitment from the Commission to consider such a carry-over when the DPP is next reset. The Commission could further enhance the incentives for efficiency gains by considering proposed specific initiatives *during* the course of the regulatory period and agreeing in advance how the efficiency benefits would be shared when the DPP is next reset.
36. Powerco notes that one theme of the Discussion Paper is the Commission's view that the DPP be a generic regime, on the basis that CPP provides an opportunity to address any issues that arise. The CPP mechanism was designed to take account of the specific needs of suppliers who had essential investment needs which could not be addressed by way of a DPP. Many firms will be able to operate under the DPP, but have to make optional investment decisions on improving quality and energy efficiency. A firm is unlikely to develop a customised proposal just to have these voluntary investment options considered.

## **Starting price adjustment**

37. Powerco supports many of the Commission's proposals with respect to assessing whether an initial price change is required when transitioning from one regulatory period to the next. Powerco interprets the two step process that the Commission has proposed as follows:
- *Step 1* – the Commission would compare the achieved return in the year prior to the new regulatory period (the 'current returns') to an allowable band for returns. Subject to step 2:
    - where returns are outside of the band then a price change would be effected to bring returns to the outer bounds of the band; whereas
    - if returns are within the band, then no price change would be required.
  - *Step 2* – the Commission would conduct scenario analyses of projected profitability and decide whether a change to the conclusions reached in step 1 is required. In this step, the Commission would concentrate on expected trends in capital expenditure (being correctly identified as the factor that is most likely to lead to a step increase or decrease in profitability), and to rely on existing sources of information for this purpose (such as the Asset Management Plans).

38. Turning first to step 2, Powerco supports the Commission's proposal to examine scenarios for projected profitability based upon trends in capital expenditure, and Powerco also supports the Asset Management Plans being used as the basis for this assessment. These Plans are a robust source of asset-related forecasts for the industry, and using this existing source of information will keep the administrative costs to a minimum.
39. In addition, Powerco notes that capital contributions can reduce significantly during periods of economic downturn. The Commission should take this into account in projecting profitability. Further, at the moment capital contributions are treated as a non-capital item and deducted from the allowable revenue. Capital contributions, as the name indicates, are of a capital nature and should be recognised over the life of the obligation.
40. Turning to step 1, Powerco acknowledges that it is prudent for the Commission to consider the expenditure incurred by the firm in the 'current year' in conjunction with the results recorded in the previous few years in order to confirm that the current year was not abnormal. However, Powerco notes that annual demand – and hence revenue – can also vary from one year to the next depending on weather conditions and customer demand.
41. Powerco also supports the Commission's proposal to test the current and projected profitability of firms against a 'band' of returns, provided that:
- the mid-point of the band is at a level that takes account of the asymmetric consequences of regulatory error – consistent with Powerco's previous argument on this matter, this would require the mid-point of the band to be at the 90 per cent confidence limit for the WACC; and
  - the lower end of the band should sit above the 50 percentile estimate of the WACC in order to avoid the situation whereby a firm that was failing to recover cost for reasons beyond its control necessarily would need to seek a customised price path in order to ensure it can finance investment.
42. As discussed above, assessing a distributor's returns against an allowed band would enable the distributor to retain some of the benefits of the efficiency gains that they achieved in the previous period, and so enhance the incentives for such gains. Remove the ability to carry-over efficiency benefits from one period to the next, poor incentives exist for businesses to pursue cost reductions. The Commission should take account of the need for such incentives when setting the range of the allowable band.
43. As also discussed above, Powerco considers that another positive initiative that the Commission could undertake to enhance the incentives for firms to seek cost efficiencies is to assess specific initiatives that the businesses have undertaken

and to permit the businesses to retain a reasonable share of the net benefit that is created into the next regulatory period. If such a mechanism is adopted, then the Commission would need to adjust for the benefit to be carried over when assessing whether a price change is appropriate for the firm (for example, by deducing the intended benefit from the profit that is calculated for the current and projected years).

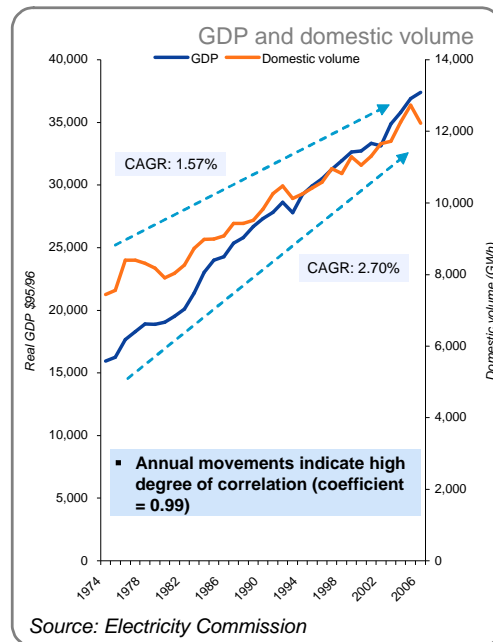
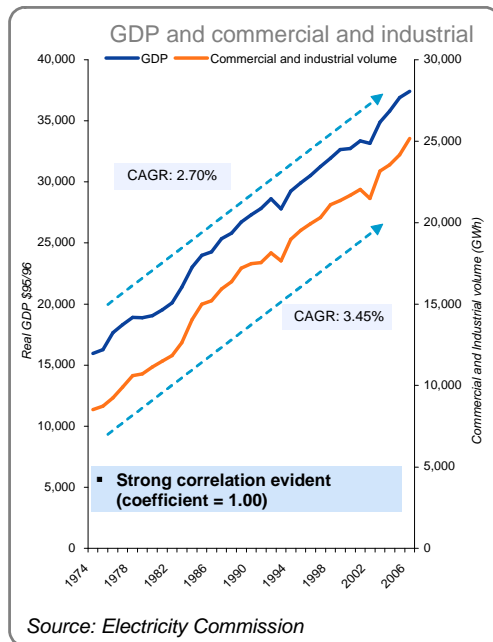
44. An important issue to be considered when assessing the current and future profitability is the form of WACC - and associated definition of profit - that is adopted. Some choices have little real consequence, most notably the question of where the tax shield on debt should be taken into account. However, others are material, most notably the question of whether the allowed band for returns should be defined in real or in nominal terms (with profit defined in a consistent manner), which determines how unexpectedly high or low inflation impacts upon the analysis. In addition, if returns are defined in real terms then a related issue is how inflation is to be forecast when determining the allowed real returns. Powerco notes that these issues relate to those raised in the parallel consultation on the WACC guidelines and Input Methodologies, and will comment upon them in that context.

## **Rates of change**

45. Powerco notes that most of the Commission's comments about the rate of change in prices (and determination of the X factor) relate to the Economic Insights report, which Powerco will respond to separately.
46. However, Powerco would like to underscore at this stage that the Commission should be cautious about applying historically achieved rates of growth in TFP to the future. First, the slowdown in the economy – and electricity demand – that has accompanied the Global Financial Crisis would be expected to reduce the prospects for future growth in total factor productivity (TFP).
47. The graphs below show that commercial and industrial consumption and domestic consumption are strongly correlated to GDP.<sup>4</sup>

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<sup>4</sup> Research by the Electricity Commission.



48. Much of the growth in TFP for utility firms derives from the fact that growth permits a greater realisation of the economies of scale, scope, density and capacity utilisation that may be present in the relevant networks – these factors imply that the technology permits outputs to grow at a faster rate than inputs, which is the definition of TFP growth. This means in turn that the rate of output growth has a material effect on the prospects for TFP growth. The Commission should expect that the rate of productivity growth that was realised in the recent past – which was characterised by a period of high economic growth – would overstate the reasonable prospects for productivity growth in the period ahead.
49. In contrast to the utility sector, most of the economy is not characterised by technology that has material economies of scale, scope, density and capacity utilisation, and so the slowdown in economic growth would not be expected to have as large an impact on economy wide TFP growth.
50. Secondly, some of the growth in TFP in the New Zealand businesses has been achieved through one-off managerial efficiency measures, especially if TFP is measured using data that dates back to the time of separation of lines and retail activities. It is unlikely that the same scope for one-off efficiency gains will exist in the future, and as a consequence more modest future rates of TFP growth should be expected.
51. In addition, Powerco notes that the purpose of the Commission’s exercise is to set a path for prices, and not to obtain the best estimate of TFP *per se*. It is expected that the definition of ‘outputs’ will again be a key issue of debate

between the relevant experts on the matter, especially given the Commission's proposal to introduce another abstract measure of output that the Commission considers will uncover 'productivity growth that is not recognised in the previous specifications'<sup>5</sup>. However, Powerco notes at this stage that the scope for price reductions only exists where *revenue* grows at a faster rate than *costs*. The growth is an abstract measure of output that does not translate into revenue growth. It is irrelevant to the price path, irrespective of whether affects a technical measure of TFP growth.

52. Lastly, Powerco draws the Commission's attention to the views of its own expert adviser that the prospects for productivity growth will be affected by operating environment factors, and in particular that:

Adverse operating environment conditions are likely to limit opportunities for future productivity growth as well as resulting in higher costs/lower productivity levels. For example, if the group being regulated are electricity distribution businesses, and some distribution businesses are located in areas of active storm activity while others are not, the distribution businesses in the bad weather areas will generally face higher operating costs and fewer opportunities for productivity improvements than distribution businesses in good weather areas. Thus, when regulating groups of firms using a single TFP or technical progress target across firms in a price cap regime, the regulator should either group the regulated firms into *peer groups* who face roughly similar operating environments or adjust the price caps for each firm according to differences in *operating environments*.

53. Powerco's electricity networks are largely located in rural areas that experience frequent severe storms. Powerco agrees with EI that a consequence of this is its networks are both more costly to operate and permit fewer opportunities for productivity growth.
54. Given that under the new Part 4 the Commission must set a generic X factor the X should be set in a conservative manner to ensure a "do no harm" approach for all lines businesses – including those that due to their physical characteristics cannot deliver the average productivity gain.

## Quality

55. Determining how to balance the trade-off between price and quality in the absence of a competitive market is not an easy task. Powerco supports the Commission's focus on reliability as an indicator of quality and its move to consider long term, rather than annual changes in quality. The use of SAIDI and

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<sup>5</sup> Supra 1, paragraph 343.

SAIFI indices to measure quality is appropriate, as these are internationally accepted measures of reliability.

56. Powerco supports the idea of an S factor and is keen to work with the Commission to develop an effective mechanism. It is important that distributors have flexibility to meet consumers' needs, and have incentives to invest in improved reliability if consumers' demand it.
57. Powerco is contributing to the ENA analysis of statistical variability of reliability performance and supports the ENA's recommendations on assessing quality compliance. Powerco appreciates the ongoing engagement of the Commission's officials and the ENA on this matter.

## Responses to questions

Q.1) How might genuine innovations be rewarded under a DPP? Please explain

Promoting innovation is a key part of the new regime and is explicitly stated in the section 52A purpose statement. Innovation is mainly related to the goal of dynamic efficiency and Powerco agrees with the Commission when it states that “the concept of dynamic efficiency [...] is arguably the most important form of efficiency in practice”<sup>6</sup>. Much larger gains in economic welfare are achievable through dynamic efficiency, compared to allocative and productive efficiency.

Powerco is concerned by the term “genuine” innovation. This suggests a forensic approach to rewarding incentives, which the Commission acknowledges is a complex matter given innovations can vary enormously. It is more important to have a clear and simple signal to distributors about rewards for innovation, rather than risk incentives being masked by complexity.

Please see paragraphs 29 - 36 of this submission on how efficiency incentives could be improved.

Q.2) Are there any other economic principles you believe are relevant to the DPP reset? If so, please explain.

The principles seem appropriate for the DPP determination.

Q.3) What are your views on the Commission’s proposal to have a single section 52P determination, which specifies requirements for each EDB?

Powerco believes the Commission’s proposal to develop a single determination is sensible, given the intention that DPPs be a generic, low-cost form of control, and the fact that most provisions are likely to apply equally to all EDBs.

We note, and fully support, the Commission’s intention to publish a draft Decisions Paper in early September 2009. Once EDBs have had the benefit of reading the Decisions Paper, and therefore have a better feel for the likely substance of a DPP, thought could be given to whether there are specific issues that require a different approach to be taken.

Q.4) What are your views on the timeframes relevant to the DPP reset?

Powerco agrees that the Commission must publish a summary of the determination by 1 December 2009, in order for the 2010 DPP to commence on 1 April 2010, given the

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<sup>6</sup> Paragraph 53.

requirement that a DPP must commence at least 4 months after a summary has been published in the *Gazette*.

Powerco considers that establishing a five-year period for the 2010 DPP (the maximum allowable) will provide the certainty for EDBs that Part 4 of the Act was designed to achieve. However, we expect to be able to give a firmer indication of the appropriate length of the regulatory period for the 2010 DPP determination once we have received the Commission's September 2009 Draft Decisions Paper.

The Commission proposes that compliance with the DPP must be demonstrated within 35 working days of the conclusion of each regulatory year. Provided that the determination specifies sufficiently clear requirements by which EDBs can demonstrate compliance, Powerco considers that a timeframe of 35 working days is reasonable.

Q.5) Are there any other relevant timeframes that should be included in a Determination?

In the interests of certainty as to process, Powerco suggests that the determination should specify a time following the conclusion of each regulatory year within which the Commission must inform EDBs of any concerns as to compliance or verification of compliance.

Q.6) What are your views on the proposed additional content of a Determination? Are there additional matters that should be considered for inclusion?

Powerco believes that the determination should include specific, simple rules around demonstration and verification of compliance. When setting these rules, the Commission must bear in mind the low-cost nature of the DPP regulatory tool. While we recognise that a certain level of verification of compliance with the DPP will be crucial to the effectiveness of the regime, overly rigorous verification requirements could quickly spoil the broad-brush character of the regime and force EDBs to bear unnecessary costs, such as audit fees.

Powerco notes that the determination is likely to include provision for the Commission to grant an exemption from the DPP. We will be interested to read in the September Draft Decisions Paper details of when the Commission believes an exemption from the DPP is appropriate.

Section 52Q of the Act allows the Commission to amend a section 52P determination in a "material" way only after consultation with interested parties, and in a "non-material" way without prior consultation. Powerco believes it would be helpful for the Commission to set out in its September Draft Decisions Paper what it believes "material" and "non-material" amendments to a determination would be.

Q.7) What are your views on the Commission's proposed approach for meeting the section 54Q requirements for promoting incentives, and avoiding disincentives, for investment in energy efficiency and demand-side management under Part 4?

Powerco agrees with the Commission that it is important to take a cautious approach when looking to implement initiatives relating to energy efficiency and demand side management. The Commission and EDBs have a common goal in this area and there is much potential to work together to create workable commercial incentives which align with the s52A purpose statement. The Commission's previous experience in setting the 2003 Threshold Notice and the 2008 Gas Authorisation indicates that unexpected problems may arise with formulas once they are applied by suppliers. Keeping the re-set simple is one way to reduce this risk.

Waiting until 2016 however, would be an overly cautious approach. Powerco is comfortable with the Commission introducing energy efficiency incentives in the middle of the regulatory period if its intentions to do this are stated at the beginning of the period and the schemes are voluntary.

There are a range of options to promote energy efficiency, some of which could be quite simple. For example, investments by suppliers to improve energy efficiency could be approved by the Commission in advance of commissioning and be taken into account in the starting price adjustment of the next regulatory period. The issue of de-coupling revenue from energy use would be a more complex area, and may take longer to develop an appropriate mechanism.

Q.8) The Electricity Commission is currently undertaking work in a number of areas relevant to electricity distribution services, which is yet to be finalised. What do you consider to be the potential impact of the Electricity Commission's work on the Reset DPP?

### *Pricing Methodology*

The Electricity Commission's work on principles or a model approach to EDBs' pricing methodologies does not align with the Commerce Commission's DPP approach. The Commerce Commission's preliminary view is that the costs associated with regulating pricing methodologies under the DPP may outweigh the benefits.<sup>7</sup>

The Electricity Commission however, are proposing that EDBs report compliance with a modified PAWG model of distribution pricing. In forcing EDBs to justify why they differ from the regulator's preferred model, the Electricity Commission is stating that its model is superior to the EDB's pricing methodology. The Commerce Commission's analysis has clearly shown that while pricing should meet certain principles, there is no one correct approach. In Powerco's submission to the Electricity Commission's consultation on model approaches for distribution pricing, we supported the Commerce Commission's

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<sup>7</sup> Commerce Commission, Input Methodologies Discussion Paper, paragraph 9.9.

position on pricing methodologies for the DPP. Powerco recommends that the Electricity Commission and the Commerce Commission align their approaches.

#### *Load management and Advanced Metering Infrastructure*

The Electricity Commission is reviewing ownership rights of load control and metering. These issues could increase the investment required by Powerco, make assets redundant and reduce revenue streams. For example, Powerco uses ripple control assets to manage load and the security of supply on its network. It receives revenue from the reserves market for this load. If this function is replaced by retailers operating advanced meters, Powerco's revenues and costs would change.

The Commerce Commission's approach to assessing profitability and re-openers should take these risks into account.

Q.10) What are your views on how the Commission should supplement the data made available under information disclosure regulation for the purposes of the DPP reset? What additional information should be requested that allows for estimates of projected profitability?

As the Commission is still to publish the new electricity information disclosure regime, Powerco can not comment on what data should supplement this.

Q.11) What are your views on how the Commission should allow for current and likely future economic conditions for the purposes of the DPP reset? How, and to what extent, will these conditions impact on regulated utilities, in particular EDBs? Please explain

The economic climate needs to be taken into account in assessing current and future profitability and in measuring total factor productivity and translating this to the X factor.

Please see paragraphs 46 - 49 of this submission on the impact of GDP on total factor productivity.

Please see paragraph 39 of this submission for the impact of economic downturns on capital contributions and on revenue.

As economic conditions affect costs, revenue and cash flows for EDBs, they will also affect the profitability of EDBs and starting price adjustments. For example, the financial crisis has also lowered incentives to invest in capital by raising uncertainty on investment returns and risk premia. In addition, firms have had to cope with less advantageous investment financing conditions due to tighter lending standards in the form of an increasing real cost of borrowing and limited credit supply. Utility businesses have ongoing requirements for capital for the renewal of existing assets, the construction of new assets to serve new customers and the construction of new assets to accommodate changes in service (i.e. reliability) requirements. It is important that the DPP regime takes this into account. For example, a business's credit rating outlook is largely driven by the

certainty of future cashflows. If the DPP significantly reduces cash flows the business may be at risk.

Predicting future profitability will also be difficult as there is so much uncertainty on the level of economic growth in the medium term.

Q.12) What are your views on whether it is appropriate and/or feasible to explicitly link price and quality performance under a single mechanism, such as an S-factor? What information and analysis would be required to implement a robust and effective mechanism?

Q.13) What are your views on the dual-path structure as proposed? What are your views on assessing EDBs against separate price and quality paths?

Powerco supports exploring an S factor mechanism and is keen to work with the Commission to develop an effective tool which puts the appropriate incentive mechanisms in place. Powerco understands the time pressures on the Commission and agrees that it would be risky to try to develop an S-factor for the 1 December 2009 determination.

Waiting until 2016 however, would be an overly cautious approach. Powerco is comfortable with the Commission introducing an S factor in the middle of the regulatory period if its intentions to do this are stated at the beginning of the period and if the scheme is voluntary.

Q.14) Under what circumstances, if any, do you think the Commission should consider re-opening a DPP within a regulatory period? Under what process should such circumstances be considered, e.g., should the industry make a proposal for the Commission to consider?

Powerco notes that in the Input Methodology Discussion Paper that the Commission's preliminary view is that no re-opener should be included in the default price-quality path, but that it should be considered for inclusion in a customised price-quality path. The Default Price Path discussion paper mainly refers to the need to have a re-opener before the Input Methodologies are determined.

Powerco supports the inclusion of re-openers and that this should include any change that would have caused a significantly different Po adjustment or X factor if the situation was known at the time. For example, if volumes change significantly or if capital expenditure increases due to a natural disaster.

While an EDB may apply for a customised path if the DPP becomes unsustainable, the Commission only has to consider four customised proposals a year. Powerco will provide further comment on this issue in response to the Input Methodologies discussion paper.

Q.15) What are your views on the appropriateness of the Commission's input methodology for pricing methodologies under the DPP? If appropriate, how and when should a related mechanism be implemented?

Powerco supports the Commission's proposal to not develop a pricing methodology input methodology for the purposes of the DPP, and instead allow EDBs flexibility in their choice of pricing methodology. Powerco agrees with the Commission that the costs of imposing the pricing methodology input methodology would outweigh the benefits.

The Commission states that it may be appropriate to allow EDBs to set prices according to guidelines prescribed by the Electricity Commission. The Electricity Commission has proposed distributors adopt the 'PAWG' pricing model, which the Commission's own advisors have previously advised is too inflexible and prescriptive.<sup>8</sup> Powerco does not support the Electricity Commission's pricing methodology proposal, and believes it will stifle distributors' innovation in pricing.

Powerco agrees with the Commission that the same approach to that under the thresholds regime should be followed. The tariff basket approach proposed for the DPP incentivises already suppliers to adopt Ramsey based pricing.

Please also see Powerco's response to question 8.

Q.16) What are your views on the proposed use of notional revenue (in a general sense) to specify price under the Reset DPP?

Powerco agrees with this approach.

Q.17) What are your views on the proposed pass-through costs including the incorporation of Commerce Commission levies?

The Commission's preliminary view is to include Commerce Commission levies as a pass through cost. Powerco supports this proposal, particularly as it resolves the inconsistency with how Electricity Commission levies were treated. The expenditure of the Commerce Commission is not within the reasonable control of distribution businesses. The Commerce Commission's expenditure is agreed with the Ministry of Economic Development each year based on outputs determined by the Ministry. Powerco has very little control over this. In addition, the current work of the Commission is to meet legislative requirements and timelines. In this case the Commission's work programme was determined by Parliament.

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<sup>8</sup> See Meyrick and Associates, Gas Distribution Pricing Principles, 6 November 2006, page 7.

Q.18) To what extent do you consider transmission charges to be outside the control of EDBs?

Powerco agrees with the Commission when it states that “as these costs [including transmission charges] are largely outside of an EDB’s control, the Commission considers that it may not be cost effective to allow for anything other than 100% pass through for the purposes of assessing compliance under a DPP”.<sup>9</sup>

Q.20) What options might there be for the promotion of energy efficiency through the specification of starting prices?

Please see Powerco’s response to question 7.

Questions 21 to 42

Please see paragraphs 37 to 44 in this submission.

Questions 43 to 52

Please see paragraphs 45 to 54 in this submission.

53) What are your views on whether annually updating the base quantities is preferable to using those from a fixed reference year? What is the minimum time period (lag) that would be required to allow the auditing of quantity data for use as the reference quantities?

The relevant quantities should pertain to the prior 31 March pricing year, for example the volumes used in the threshold equation for the year ended 31 March 2010 should be the volumes for the twelve months ended 31 March 2009. This fits with the timeline to finalise prices at the end of 2009. Using a year which mirrors the pricing year reduces compliance cost and complexity as it allows any tariff structure changes to be taken into account.

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<sup>9</sup> Paragraph 204.

Q.54) Would the use of a lagged CPI measure in price-path compliance lead to the removal of CPI forecast errors? Would a six month lag between the most recent quarterly CPI change used, and the start of the pricing year allow businesses sufficient time to implement pricing changes?

Q.55) Are there alternative ways of including the CPI change that may be preferable to using lagged actual values while avoiding technical breaches, e.g., using an agreed recognised forecast of the CPI?

The Commission's preliminary view is to use a lagged CPI index, similar to the approach taken in the Gas Authorisation. Powerco supports using a lagged or forecasted CPI index as it is important to minimise the number of technical breaches of the default price path due to the more serious consequences of breaching. While the Commission has discretion in imposing penalties, a breach will create uncertainty for the EDB.

Q.56) Have you any views on the inclusion of Commerce Act Levies as a pass-through cost under the DPP?

Please see Powerco's response to question 17.

Q.57) What are your views on the treatment of transmission charges as pass-through costs? How might avoided transmission charges be taken into account?

Please see Powerco's response to question 18.

Q.58) Should the Commission seek to address the pass-through anomaly identified under the thresholds regime? If so, what is the most appropriate mechanism for doing this?

Q.59) How feasible would it be to 'unbundle' distribution and transmission charges and, if so, how could this be done with least complexity? To what extent would such a mechanism address potential technical breaches relating to AC loss rental rebates?

Q.60) Alternatively, do you consider that an *ex post* approach might reduce the impact of the anomaly while increasing certainty?

Powerco agrees that ideally the "anomaly" should be addressed and that this should be done by changing the price path formula. At this stage Powerco does not consider that transmission and distribution should be unbundled in the DPP [same question re ENA]. Transmission (including avoided transmission costs) should be treated as a direct pass-through cost, with the quantity adjustment in the specification of the DPP providing a simple solution to the volume anomaly. Further incentives for managing transmission costs can be explored and included at a later date along with energy efficiency incentives.

Q.61) What are your views on the use of a separately assessed quality-path? Is such an approach appropriate for promoting incentives for EDBs to provide services at a quality that reflects consumer demands? If not, please explain.

Please see Powerco's response to question 12.

Q.62) In your opinion, to what extent should increased investment deliver higher levels of quality.

Powerco agrees with the Commission that there is a correlation between investment and levels of service quality. The quality path therefore has an important relationship with this objective. The Commission should recognise that the level of investment needed to increase reliability may be significant. Since 1 July 2002 the amount that Powerco has invested in its electricity distribution network assets has increased by more than 100%. Over the same period there has been a real price reduction of 6% of Powerco's electricity prices. Although Powerco's investment in its electricity assets has more than doubled in the last seven years, Powerco's network reliability (as measured by SAIDI) has been largely static. This is a clear demonstration of the magnitude of investment needed for to replace ageing assets and to augment network security and capacity to accommodate growth.

Powerco is forecasting a major challenge between investment and reliability outcomes. Powerco is not able to continue to invest at such high levels without being certain that it can recover costs of those investments from the price path. More detail on this is provided in Powerco's 2009 Asset Management Plan. This is a challenge that we look forward to working constructively with the Commerce Commission to ensure sufficient investment incentives.

Q.63) What other methods could be used to determine the price-quality trade-off deemed most appropriate by consumers?

Powerco agrees with the Commission that there are numerous difficulties with trying to understand the price quality trade-off preferred by consumers. The average electricity consumer has limited knowledge of the complexities of the electricity industry and in many cases is not in a position to provide meaningful feedback on its preference. Mass market consumers tend to be apathetic about the reliability of electricity supply and interruptions are rare for many customers. The work to develop an S factor in the future should take this into account.

Q.64) What are your views on the use of a 'no material deterioration' basis in the quality standard, and how it may be appropriately reflected in the quality standard?

Powerco agrees that a "first principles" approach to the quality path would be resource intensive. Powerco supports the use of a "no material deterioration" standard in quality as

the next best alternative. Powerco agrees with the Commission that this should be a deterioration that is serious or significant and agrees with the Commission's statement that "the Commission interprets such a standard to mean that short-term variations in the quality-path caused by external factors out of the control of EDBs, do not necessarily constitute material deteriorations in quality". Quality should be measured over a long period of time.

Q.65) What do you consider are appropriate criteria for demonstrating an EDB's responsiveness to consumers?

The Commission refers to the Parson Brinckerhoff Associates (PBA) report in discussing criteria for customer consultation. In addition to discussion on quality standards the report states,

The introduction of service quality measures into the quality thresholds is recommended. [...] It is therefore suggested that local performance data should be collected to use for appropriate target setting at the following reset. Further consultation is required on what the appropriate service quality indices should be, but we suggest that this be drawn from the following broad categories:

- quality of telephone response (typically the percentage of calls not answered within a set time, the number of "dropped" calls, etc.);
- average time to respond to customer problems;
- average time to substantially address customer queries;
- average time to provide connections (or some other distribution service);
- percentage of connections (or other distribution service) not provided at the agreed date; and
- annual number of service complaints received (resolved and unresolved).

The Commission does not state if it proposes to add these additional requirements to the information disclosure regime. Powerco will provide a more detailed response to this issue if it arises in the upcoming Information Disclosure Discussion Paper. At this stage Powerco would like to state that it does not believe that this level of reporting is justified.

The reason for quality reporting is to ensure EDBs do not reduce expenditure to earn higher returns on investment. Expenditure on customer service is minor compared to capital expenditure and customer service would have to be dramatically reduced to make any noticeable impact on return on investment.

This level of reporting will also increase compliance costs. Powerco is required to report on 15 quality indicators under the Gas Authorisation. Many of these indicators are similar to the PBA suggestions above. The cost to Powerco to implement systems to provide the auditable data required was significant.

Customer service is intrinsically linked to the separation of retail and distribution. It will be very difficult to effectively measure EDBs' performance on these points under the current industry structure of an interposed customer relations model. While EDBs could provide data on these measures, it would give a limited indication of the overall customer experience. Powerco has no control over what time has elapsed or what interaction has taken place between the customer and the retailer before Powerco becomes involved. The interposed model means that Powerco's efforts to work with retailers are as important as how quickly telephone calls are answered. If the Commission would like more information on customer service, a better indicator is the number of complaints submitted to the Electricity and Gas Complaints Commission each year. This gives a much better overall picture of how distributors are engaging and responding to customers.

Q.66) What do you consider is the most appropriate regulatory mechanism under Part 4 for including a customer communication criterion?

The Commission states that it "considers that such performance measures may be better suited under information disclosure regulation"<sup>10</sup>. Powerco supports moving the consumer communication criterion to the information disclosure regulatory instrument as it is a subjective indicator and should not be part of a mechanism where penalties can potentially be imposed.

Questions 67 – 75

Powerco is contributing to the ENA analysis of statistical variability of reliability performance and supports the ENA's recommendations on setting quality standards and assessing quality compliance.

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<sup>10</sup> Ibid., paragraph 4.2.