

**Submission on the
Reset of the DPP for Electricity Distribution
Businesses
Draft Decisions Paper**

From the Electricity Networks Association

12 October 2009

Table of Contents

1. Introduction	1
2. Executive Summary	2
3. Form of Default price-quality path	3
Re-openers	3
4. Energy efficiency and demand-side management	4
5. Form of price path	5
Quantities	5
CPI	6
Pass through costs	7
Price path formula	7
Possible s factor	8
Excluded services	9
6. Rate of change	10
7. Quality standards	10
Normalising for extreme variation	11
Accounting for normal variation	11
Non contiguous network quality data	12
8. Compliance Assessments	12
9. Next Steps	13
Development of Enforcement Guidelines	13
Final decision and technical drafting	13

1. Introduction

1. This submission, from the Electricity Networks Association (ENA), is in response to the Commerce Commission's draft decisions on the Reset of DPP for Electricity Distribution Business (Decisions Paper).¹
2. The Decisions Paper is the penultimate step in a series of consultations between the Commission and interested parties on the Reset of the default price/quality path (DPP) for electricity distribution businesses (EDBs). The ENA has submitted in response to each of the Commission's papers to date and has also proposed on its initiative how some aspects of this Reset could be implemented. We are heartened by a number of the decisions set out in the Decisions Paper and the acknowledgement of the views of the industry in a number of the draft decisions. In this submission we do not re-work the points made in previous submissions, we have however indicated briefly the draft decisions that we support, and we have also highlighted those draft decisions which we do not support setting out our justifications for our proposed alternatives.
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4. This submission is also supported by the following two further submissions commissioned on behalf of ENA members:
 - Pacific Economics Group – Total Factor Productivity Analysis
 - Statistical Research Associates – Measuring Quality Standards.

¹ *Reset of the Default Price-Quality Path for Electricity Distribution Businesses, Draft Decisions Paper*, 8 September 2009, Commerce Commission

2. Executive Summary

5. The ENA supports a number of the draft decisions set out in the Decisions Paper, and has acknowledged these throughout the body of this submission. There remains however a number of issues of concern in the draft decisions as summarised below.
6. The ENA submits that re-openers are necessary for the DPP and provision for them should be included for them from the outset with recognition that processes and rules in relation to re-openers may be modified once Input Methodologies are determined.
7. The ENA acknowledges and supports the Commission's intention to allow EDBs flexibility in their tariff structures, within the Allowable Notional Revenue constraint of the default price path. However, the ENA does not concur that this will provide an effective counter to the disincentive of price cap regulation for EDBs to promote energy efficiency.
8. The ENA supports a t-2 approach to defining quantities for the price path. The alternative t-1 approach introduces unnecessary uncertainty into the price path and it is highly likely that there will be considerable variances between actual and estimated quantities under the t-1 approach given the significant movements and wash ups which occur during the year.
9. The change in the CPI definition to a lagged CPI introduces a discontinuity into the CPI series used to set the price path. In order to maintain continuity a forecast CPI should be used with an adjustment in the following year for the difference between forecast and actual CPI.
10. Pass through costs should also include provision for the pass through of costs associated with new legislation or regulation. Pass through costs may also be specified to provide for the recovery of costs associated with a major unforeseen event.
11. The proposed price path formula is inconsistent with a price cap approach to regulation as it has the effect of resetting Allowable Notional Revenue each year based on the previous year's actual prices. It should be amended to provide for recovery in future years of headroom established in previous years (and avoid locking in any prior year over recoveries).
12. The ENA fully supports the Commission's commitment to undertaking further work on a possible s-factor mechanism, with a view to implementing it within the regulatory period.

13. The DPP should provide for excluded services similar to the provisions in the current thresholds as per sub clauses (d) and (j) of the definition of excluded services. In addition the DPP should allow for prices and quality standards for electricity lines services to be set by the suppliers and purchasers of those services where there is a written agreement between them that they agree to remove these services from the terms otherwise set out in a DPP.
14. The ENA does not support the proposal to require relevant EDBs to derive separate SAIDI and SAIFI datasets for each non-contiguous network. This proposal is inequitable, inconsistent with the price path component of the DPP and unnecessary as disaggregated SAIDI and SAIFI performance for non-contiguous networks can be assessed from information disclosure data.
15. The ENA urges the Commission to develop and publish its Enforcement Guidelines prior to the Reset DPP coming into effect.
16. The proposed one week consultation period for technical drafting for the DPP Determination is insufficient and interested parties require at least two weeks for this purpose.
17. In addition, the ENA fully supports the accompanying submissions from PEG (on TFP and the X factor) and SRA (on normalising and assessing reliability performance).

3. Form of Default price-quality path

18. We support the following draft decisions in respect of the form of the DPP:
 - A single determination for all EDBs
 - Separate price and quality paths
 - Customer communication criterion to be excluded from the quality path
 - DPP to apply for a period of five years
 - No CPP proposal dates to be included in the DPP determination.

Re-openers

19. We note the draft decision to defer any decision on the inclusion of re-openers until after Input Methodology determinations have been made. In addition the Decisions Paper indicates that the Commission considers that re-openers should

be limited to events which affect the industry as a whole and which cause significant cost increases across all EDBs.

20. As previously submitted the ENA consider re-openers are necessary for the DPP, as EDBs need the flexibility to respond to extreme events that affect the industry as a whole, or an individual EDB (e.g. a major earthquake). Such events may not necessarily affect all EDBs, and may not also only affect costs, as there is likely to be quality and revenue impacts from some of the events which would trigger the need for a re-opener. In addition, the impact of such events will be immediate and it is not appropriate to rely on CPP processes therefore which are more suited to future needs.
21. The ENA is accepting that the Input Methodology consultations in respect of CPPs may assist in defining processes and rules in respect of re-openers, however these are also relevant for the DPP. We therefore submit that provisions should be included in the initial DPP for re-openers from the outset with recognition that the processes and rules may be modified once the Input Methodology determinations are made.

4. Energy efficiency and demand-side management

22. We note the Decisions Paper's acknowledgement of the section 54Q energy efficiency requirements and have previously submitted at length on the mechanisms which the ENA believes could be usefully incorporated into the DPP in order to fulfil these requirements. We are disappointed that very little progress has been made on these by the Commission in developing the DPP for the initial reset at 1 April 2010.
23. The ENA acknowledges and supports the intention to engage in 2010 on possible energy efficiency and demand side mechanisms and the recognition in the Decisions Paper that the Commission has the ability to amend the determination within the regulatory period to incorporate future mechanisms. ENA members fully support these initiatives and look forward to contributing to these future work streams as soon as possible in the new year.
24. The ENA acknowledges and supports the Commission's intention to allow EDBs flexibility in their tariff structures, within the Allowable Notional Revenue constraint of the default price path. However, the ENA does not concur that this will provide an effective counter to the disincentive of price cap regulation for EDBs to promote energy efficiency.

5. Form of price path

25. We support the following draft decisions in respect of the form of the price-path component of the DPP:
- The price path is to be specified using a form of Notional Revenue measured as price times a defined quantity for that price
 - The definition of price will be the same as the “posted price” definition currently applied in the price path threshold
 - Starting prices will be the prices that apply at 31 March 2010
 - Further decisions on adjustments to starting prices will be made after Input Methodology determinations are made
 - The DPP will not specify pricing methodologies to be used
 - Transmission and distribution prices will not be unbundled
 - Pass through costs will include transmission costs (including avoided transmission costs), local authority rates, Electricity Commission² levies and Commerce Act levies (including Commerce Act levies arising during the 2009/10 year to be amortised evenly over the five year period of the DPP).

Quantities

26. In addition, the Decisions Paper proposes that for the purpose of the price path, the quantities used in defining Notional Revenue and Allowable Notional Revenue are updated annually to ensure they are more aligned with current pricing structures and the volumes inherent in the pass through costs. The ENA supports this approach.
27. The draft decision is that t-1 quantities are used in the price path formula. These quantities would not be known with certainty at the time prices are set (typically prices are set in December, to apply from the beginning of the following pricing year at 1 April). Accordingly the draft decision recognises that estimates will need to be made, and proposes that the Commission will monitor the accuracy of such estimates by requiring an additional compliance step when annual

² We note the Electricity Market Review has recommended that the Electricity Commission is replaced. It would be prudent for the DPP to provide for the possibility that Electricity Commission Levies may be replaced with a new industry levy (or levies).

compliance assessments are submitted. This additional compliance will require each EDB to publish the quantities assumed when prices were set, and the actual quantities for the t-1 period. Variances greater than 5% are to be monitored. It is not clear what purpose the monitoring will serve.

28. The ENA does not support the draft decision. The ENA submits that t-2 quantities should be used instead. These will be known with certainty when prices are set, thus removing a significant potential source of uncertainty from the price path. It is also important to understand that although two thirds of the t-1 year has passed when prices are set, the quantity information available at that time contains estimates and there are significant movements and wash ups which occur through out the year, and in particular at year end. EDBs have little influence on this process as the data is managed by retailers and is subject to the market reconciliation processes. It is therefore highly likely that there will be considerable variances between actual and estimated quantities under the t-1 approach to the DPP.

CPI

29. The ENA also notes the draft decision for a lagged CPI to be used in the Allowable Notional Revenue formula. This is to remove uncertainty from the indexation component of the price path. The proposal is that the CPI will be lagged by six months prior to the beginning of the assessment period. We accept the lagged CPI will achieve this objective. We are concerned however about the implications of the change from the current price path threshold which applies the CPI applicable to the assessment period (with a lag of one quarter to accommodate data availability constraints).
30. This change in the definition of the CPI variable introduces a discontinuity into the CPI series used to set the price path. It has the effect of double counting the CPI used to set Allowable Notional Revenue for the 12 month period ending September 2009 (as this will apply in the assessment period ending 31 March 2010 and the assessment period ending 31 March 2011). Although the September quarter data is not yet available, this 12 month period is expected to include some of the lowest inflation recorded since the CPI-X price path threshold was introduced on 1 April 2004. It is unreasonable therefore to set price constraints for EDBs on this basis, where there will be no opportunity for recovery of the higher costs actually incurred in the future. In addition, there is a reasonable risk that inflation may increase at a rate greater than expected due to loose monetary policy settings overseas. Accordingly, there may be a significant lag in adjusting for inflationary pressures, under the Commission's proposals.
31. In order to maintain continuity in the CPI series used to set Allowable Notional Revenue for the price path and to reduce the uncertainty which currently exists

in the thresholds, the ENA submits that forecast CPI should be used for the purpose of the DPP price path.

32. As previously submitted, forecasts of CPI are available from both Statistics New Zealand and the Reserve Bank on a quarterly basis, suitable for the DPP. If these were made available to EDBs prior to when prices are set (say by the end of the September quarter) then the same CPI could be incorporated into price setting as used in DPP assessments.
33. It will be appropriate to allow an adjustment in the following year for the difference between the forecast CPI and actual CPI in the DPP, as the actual costs faced by EDBs will reflect the actual, not forecast CPI for each assessment period.

Pass through costs

34. We have previously submitted that additional provision for a pass through of any costs associated with new legislation or regulation or a legislative or regulatory change is included in the DPP determination. This submission has not been recognised in the Decisions Paper and provisions for such pass through costs are not included in the draft decisions.
35. As previously noted a similar provision has been included in the gas authorisation which allows controlled businesses to apply for additional pass through costs prior to the beginning of the pricing year for pre approval by the Commission. The same process could apply for the DPP. An example of a regulatory change that could impose costs on EDBs are the potential new requirements imposed by the Electricity Commission on EDBs to invest in additional voltage support equipment to meet new unity power factor requirements in the Connection Code (this is a regulatory change shifting costs from generators to EDBs).
36. The ENA therefore submits that pass through costs should include costs associated with new legislative or regulatory requirements for EDBs.

Price path formula

37. The specification of the price path formula set out in Appendix B of the Decisions Paper has the effect of resetting Allowable Notional Revenue each year, based on the previous year's actual prices adjusted by CPI-X. This is a change in approach to the price path threshold which derived Allowable Notional Revenue as a continuous annual adjustment for CPI-X. This has the effect of removing any headroom (or locking in any over recovery) that may exist in the compliance position for an EDB in the subsequent year. As the consequences of not complying with the DPP are significantly more severe than

under the thresholds regime, it is reasonable to expect EDBs may choose to set prices slightly below the estimated Allowable Notional Revenue.

38. Although a number of changes to the price path formula (particularly the CPI and quantity specifications) are designed to remove uncertainty from the price path, not all uncertainty can be eliminated. Pass through costs are not known with certainty in advance. Some elements of transmission charges are, but connection and new investment charges may not be, nor will avoided transmission charges in all instances. In addition, Commerce Act levies, local authority rates and Electricity Commission levies are not known with certainty at the time prices are set for the forthcoming pricing year.
39. Accordingly, the ENA submits that the price path formula should incorporate allowances for recovery in future years of headroom established in previous years. This has been effectively incorporated into the price path threshold to date. The amendment would apply from the second year of the price path as follows:

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

Where ΔCPI reflects the difference in actual versus forecast CPI.

Possible s factor

40. The Decisions Paper indicates that the Commission considers there is insufficient time to design and implement an “s” factor as part of the DPP determination to apply from April 2010. The Commission however has indicated that it is planning to undertake further work on this topic and may amend the initial DPP determination within the next regulatory period should a robust s factor mechanism be developed following further investigation.
41. The ENA accepts this timing issue and fully supports the Commission’s commitment to a project to develop an s factor; with a view to implementing it within the regulatory period to provide EDBs an opportunity to be compensated for improvements in quality should they so choose.

Excluded services

42. The Decisions Paper makes no mention of the provision for excluded services in the DPP. The ENA has previously submitted at length on this issue³ and has not repeated the full discussion in this submission.
43. In summary however, the scope of regulation under Part 4 is defined in the Act and not left to the Commission to determine. Thus in ENA's view the concept of "excluded services" as used under Part 4A does not carry over to Part 4. However, the Commission does have the discretion to treat some services that are subject to the DPP differently to others. It is this discretion that could and in our view should be used to ensure that those electricity lines services for which there is workable competition, or which are being supplied as a result of a competitive bidding process, are subject to the price restraints and service standards resulting from those processes, and not to the price caps and service standards set by the Commission in the DPP. These are the services that were excluded under subclauses (d) and (j) in the definition of "specified services" in the Thresholds Notice.
44. The definition of electricity lines services in section 54C addresses this issue in part by excluding in that definition:
- (e) conveying electricity only by a line or lines that are mostly in competition with a line or lines operated by another supplier of electricity lines services that is not an associate of the person, provided that the competition is actual competition and not potential competition:*
45. However, this exclusion does not capture the situation where, for example, a large consumer conducts a competitive bid process for the provision of electricity lines services resulting in a long term contract for the supply of these services, and the building of only one set of electricity lines.
46. To provide for this type of situation, which was reflected in (j) of the "specified services" definition under Part 4A, we recommend the DPP allow for prices and quality standards for electricity lines services to be set by the suppliers and purchasers of those services where there is a written agreement between them that they agree to remove these services from the terms otherwise set out in a DPP.

³ *Submission on the Reset of the DPP for Electricity Distribution Business*, Electricity Networks Association, 17 July 2009, pages 8-11

47. Note we do not consider it necessary to complicate this arrangement with a test of workable and effective competition (as was the case in (j) above), as the purchasers of the service are best placed to determine whether or not they wish these services to be carved out in this manner.

6. Rate of change

48. The ENA acknowledges the Commission's draft decision in respect of the rate of change to apply and appreciates that this represents consideration of the two alternative approaches proposed by Economic Insights (EI) and Pacific Economics Group (PEG), as well as other external factors. The ENA supports the draft decision that the rate of change (X factor) will be set at 0% per annum for all EDBs for the Initial DPP.
49. As the draft decision included for the first time the analysis undertaken by EI in forming its views on EDB TFP, the ENA has commissioned PEG to review the work undertaken by EI, which is submitted as a separate paper accompanying this submission. In addition, PEG has provided further explanation regarding the approach it adopted in its own TFP analysis previously submitted to the Commission.

7. Quality standards

50. In relation to quality standards the draft decision is that the quality standards will be set on the premise of 'no material deterioration' in service quality. In order to assess quality standard performance, SAIDI and SAIFI reliability measures are proposed to be used. The quality standards are to be set using the SAIDI and SAIFI performance for each EDB for the period 1 April 2005 – 31 March 2009 after normalising for extreme variation. The ENA supports these draft decisions.
51. The draft decision also includes details of the approaches to be adopted in normalising for extreme and normal variation in quality performance. The ENA has previously commissioned SRA to consider both of these issues and recommend statistically robust ways of achieving these objectives. SRA's views were submitted to the Commission on behalf of the ENA in July 2009.⁴

⁴ *Comments on Chapter 8 of the Commerce Commission Discussion Paper, Reset of Default Price-Quality Path for Electricity Distribution Businesses, 19 June 2009*, Statistical Research Associates, 30 July 2009

Normalising for extreme variation

52. The draft decisions on normalising for extreme variation propose that:
- the process set out in the IEEE standard for deriving boundary values is applied (known as the 2.5 Beta method),
 - major event days (MEDs) are identified using SAIDI boundary values
 - SAIDI MEDs are substituted with the SAIDI boundary value
 - where SAIFI exceeds the SAIFI boundary value on a SAIDI MED, SAIFI MEDs are substituted with the boundary value (where SAIFI exceeds the SAIFI boundary on a non SAIDI MED, no adjustment is made)
 - the resulting dataset comprises the Normalised Assessment Dataset for SAIDI and SAIFI.
53. The same approach is applied to the reference dataset to derive the quality standard Reliability Targets for the DPP.
54. The draft decision differs to the SRA recommendations in the manner in which non event days are treated, the assumption of log normal distributions for MEDs, and in replacing the MED values with the boundary value. The ENA has commissioned SRA to respond specifically to these aspects of the draft decisions.
55. In addition, the ENA does not support the proposal that SAIFI MED days are defined with reference to the SAIDI dataset. The SAIFI component of the quality path is an independent dimension of the DPP to the SAIDI component. A failure to meet the SAIDI or the SAIFI standard will result in a failure to comply with the DPP. For this reason, MEDs should be defined using the characteristics of the dataset to which they are applied, for the purpose of normalising for extreme variation.
56. Not all major events influence SAIDI and SAIFI in similar ways. This is illustrated by the number of threshold breaches reported since 2005 which reflect a breach of either SAIDI or SAIFI not both. Accordingly the ENA submits that Steps RT3 and AA2 as set out in Appendix C of the Decisions Paper should be reconsidered and if possible altered to include an additional step where MEDs for SAIFI are identified using the SAIFI boundary value.

Accounting for normal variation

57. The Decisions Paper indicates that normal variation will be accounted for when defining the Reliability Target by adding a dead-band to the Reference Dataset

equal to one standard deviation (to be calculated from the Reference Dataset). The ENA supports this draft decision.

58. In addition, the Decisions Paper indicates that the annual assessment is to be assessed using a two step test as follows. The quality path will be met if:
- The annual assessment is less than or equal to the Reliability Target for SAIDI and SAIFI; or, if this test fails
 - The annual assessments of SAIDI and SAIFI in the previous two periods did not exceed the Reliability Target.
59. The ENA supports the two step test for the purpose of accounting for normal variation, and the use of a multi year test for the second step, for this purpose.

Non contiguous network quality data

60. The draft decision also indicates that EDBs with non-contiguous networks are to derive separate SAIDI and SAIFI datasets for each non-contiguous network. Although not explicitly illustrated in the worked examples in Appendix C, this implies that those networks meeting the non-contiguous network definition will be required to meet an increased number of tests in order to fulfil the requirements of the DPP. The ENA does not support this draft decision because:
- The separation of the quality path into sub network reliability standards increases the number of tests that must be met by affected EDBs. This is inequitable, as it increases the probability of a failure to comply, as not all normal variability can be accounted for in the design of the quality component of the DPP;
 - Separating the quality path into non contiguous networks is inconsistent with the price path component of the DPP. The DPP reflects an inherent relationship between price and quality, which is inconsistent with this proposal; and
 - The information disclosure requirements include separate disclosure of reliability performance for non-contiguous networks. This is appropriate and provides sufficient information for performance monitoring purposes.

8. Compliance Assessments

61. The ENA supports the draft decision to allow 50 working days for submission of annual compliance assessments.

9. Next Steps

Development of Enforcement Guidelines

62. The Commission proposes developing Enforcement Guidelines to give suppliers greater certainty about the steps proposed for compliance and enforcement matters associated with the DPP.
63. As previously submitted the ENA welcomes and supports this initiative and urges the Commission to develop these in conjunction with the DPP and publish them prior to the Reset DPP coming into effect to assist achievement of regulatory certainty and transparency.

Final decision and technical drafting

64. The Decisions Paper indicates that a final draft decision will be made available in mid November, along with a draft determination. The draft determination will be subject to a one week technical drafting consultation period. The ENA submits that this period is insufficient to enable interested parties to test and consider the definitions, formula and other requirements such as the form of auditors' reports and the information to be included in compliance assessments. The ENA submits that interested parties require at least two weeks for this purpose, which will assist in removing any potential errors or over sights in the final determination.