

**Submission on the  
Reset of the DPP for Electricity Distribution  
Business**

From the Electricity Networks Association

17 July 2009

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## 1. Introduction

1. This submission, from the Electricity Networks Association (ENA), is in response to the Commerce Commission's paper on the Reset of DPP for Electricity Distribution Businesses (Reset Paper)<sup>1</sup>.
2. The Reset Paper is another step in a series of interchanges 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. In this submission we do not re-work the points made in previous submissions, but rather indicate the approaches in the Reset Paper that we support, and those which we consider need to be improved, with recommended ways as to how they could be improved.
3. ENA's contact person for this submission is:

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4. The submission is ordered consistent with pages iii to vi of the Executive Summary of the Reset Paper for ease of reference, that is:
  - Default price-quality path and EDBs
  - Energy efficiency and demand-side management
  - Default price-quality path reset
  - Starting prices
  - Rates of change
  - Quality standards

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<sup>1</sup> *Reset of the default price-quality path for electricity distribution businesses*, 19 June 2009, Commerce Commission,

5. Answers to the questions posed in the Reset Paper are appended.
6. There are two topics raised in the Reset Paper that we wish to develop further and discuss with ENA members prior to submitting on them in a detailed manner. ENA members will be meeting on 28 July for these discussions and we intend to submit further on these topics by 31 July. We anticipate this process will lead to a clear set of proposals that have broad sector support. In this submission we have provided some initial views on each, as we recognise time is short. These topics are:
  - TFP analysis and its application to setting “X” including specifically gaining a better understanding of the Economic Insights TFP proposals; and
  - quality standards.
7. The ENA also notes that the current consultation processes are placing considerable demands on its members in particular given the simultaneous consultations being undertaken on a number of topics. As submitted previously we find these formal consultation processes sub-optimal.<sup>2</sup> We therefore encourage the Commission to consider alternative approaches to its consultation including direct engagement between stakeholders (including the ENA) and Commission staff on implementation issues. We also urge the Commission to include as much detail as possible (including worked examples) as early as possible in its consultations to enable affected parties to fully consider the implications of the options being proposed and make informed responses to the consultation papers.
8. The Reset Paper suggests that the generic and cost effective nature of the DPP limits the complexity that may be introduced into the DPP and therefore precludes consideration of a number of options which are required by the Commerce Act and which have been raised by the ENA in its previous submissions, such as energy efficiency and incentives for improving quality. While there appears insufficient time to consider quality and energy efficiency the Commission does recommend increasingly complex methods for determining the X factor and starting prices. We believe the Commission has an obligation to carefully consider the proposals put forward by interested stakeholders including those which may be additional or alternative to those proposed in the Reset Paper. Where it is not possible to develop the implementation details prior to the reset determination, it should be possible to embed appropriate mechanisms in the DPP now, with an implementation path that follows.

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<sup>2</sup> *Submission on Commerce Commission Discussion Paper*, Section 3, 16 February 2009  
Electricity Networks Association

9. The Reset Paper also refers to a forthcoming paper from the Commission on the Consumer-owned EDBs which is scheduled to be released for consultation in early July 2009. The ENA is concerned the Commission is taking so long, and making such a complex issue of these exemptions.

## 2. Default price-quality path and EDBs

10. The Commission proposes to design the DPP determination as follows (paragraph X11):
- *the Commission proposes to give effect to its decisions in relation to the Reset DPP by way of a single determination, which will set out the relevant requirements for all EDBs;*
  - *the Reset DPP should apply for a period of five years (i.e., 1 April 2010 to 31 March 2015)<sup>3</sup>; and*
  - *the determination should address specific matters required under the Act and additional components (e.g., including matters relating to interpretation and compliance requirements).*
11. The ENA supports each of these points.
12. In relation to the third point, Table 3 on page 23 of the Reset Paper sets out in more detail the specific matters the Commission proposes to cover in a DPP determination. The ENA agrees that all the points listed on Table 3 should be covered in a DPP determination, and wishes to make the following two points:
- *“change in circumstance” is described on page 25 as “provisions to take account of possible scenarios that change how a supplier’s goods or services should be regulated.” We question what in practice is intended under this point.*
  - *There is no heading for “re-openers” and we consider there needs to be re-openers in a DPP, rather than relying on a customised price/quality path (CPP) as suggested in the Reset Paper. We discuss this in more detail below.*

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<sup>3</sup> Also refer to the earlier submission for an alternative regulatory period option supported by the ENA - *Potential Reset of the DPP and Claw-back Subsequent to Publishing Input Methodologies*, Section 4, 18 May 2009, Electricity Networks Association

### 3. Energy efficiency and demand-side management

13. In relation to the energy efficiency requirements on the Commission under clause 54Q of Part 4 of the Commerce Act the Reset Paper states (paragraph X13):

*The Commission is of the view that the section 54Q requirement relating to energy efficiency and demand-side management applies to Part 4 as a whole. Information disclosure regulation and customised price-quality paths may be more effective avenues for promoting energy efficiency, demand-side management, and reductions in energy losses. This is because of the complexities of incorporating such a mechanism within the DPP and due to the generic and cost-effective nature of the DPP.*

14. The ENA disagrees that information disclosure and CPPs may be more effective avenues for promoting energy efficiency than the DPP. We expect most non-exempt EDBs will be subject to a DPP (rather than a CPP) for most of the time and hence it is the DPP that will provide the regulatory context for most of the market. If the design of the DPP does not provide incentives, or creates disincentives for energy efficiency activities, information disclosure requirements will not remedy those deficiencies.
15. The ENA also disagrees that issues of complexity, and the generic and cost-effective nature of the DPP, preclude the crafting of energy efficiency incentives into the DPP. We recommend three possible DPP incentive mechanisms below.
16. The ENA submitted a paper<sup>4</sup> on principles to implement the 54Q requirements and practical ways in which EDBs could improve the efficient use of energy if they had the incentives to do so. This material was not incorporated into the Reset Paper. A number of the proposals in the ENA paper are relevant to input methodologies and we will raise them again in that context, but there were also at least three items that have direct relevance to the Reset of the DPP:
- The development of financial incentives for EDBs to manage transmission demand peaks.
  - The ability under the DPP for an EDB to restructure its prices within a regulatory period, in order to be able to implement price structures that are more conducive to the efficient use of energy. As noted in our 18 May

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<sup>4</sup> *Energy Efficiency Incentive Issues*, 18 May 2009, Electricity Networks Association

paper, an EDB faces revenue risk when changing price structures, arising from uncertainty as to how consumers will respond. Any price-change mechanism needs to take this transitional issue into account by, for example, allowing an EDB to re-balance price levels subsequent to trialling a new price structure for a period, or allowing some kind of ‘overs and unders account’ to reduce the risks of consumers reacting to price changes more or less than anticipated. Without such mechanisms the revenue risk to the EDB is likely to create sufficient disincentive for it to not make changes.

- The introduction of an incentive mechanism for incremental investment in system fixed assets to reduce lines losses (e.g. investment in low loss versus normal transformers). Currently EDBs’ incentives are to minimise cost, rather than to take into account investment opportunities to reduce losses in cost effective ways. As the timing for the Reset is tight it may not be possible to complete the implementation detail of such a mechanism prior to the DPP determination in November, but it should be possible to embed the mechanism in the DPP with an implementation path that follows. For example a simple mechanism may involve adjusting the quantities in the DPP to reflect the impact of the loss reduction investment initiated by the EDB. This would allow financial compensation for the lost revenue resulting from such investment to be included in the DPP in a simple way. Similarly this mechanism should apply to energy efficiency investments or demand side initiatives made by EDBs where they accord with government policy statement objectives.

17. The 54Q requirement on the Commission is to “*promote incentives*” and to “*avoid imposing disincentives*”; the Commission’s actions must comply with both tests “*when applying this Part in relation to electricity lines services.*” This requirement therefore applies to all Commission activities under Part 4, and does not, in our view, allow for selective application as suggested in the paragraph quoted above. This is particularly important in the context where, as noted above, the DPP will likely be the regulatory framework for most non-exempt EDBs.

## 4. Default price-quality path reset

18. The key points raised in the Reset Paper under this heading are (paragraphs X14 – 15):
- *The Commission considers that a DPP with separate price and quality paths is conceptually appropriate. This is consistent with the DPP currently in effect, which extends to 31 March 2010 ...*
  - *The Commission’s preliminary view is that price should reflect previous approaches used under the initial DPP, which specify ‘price’ as a function of prices charged and associated quantities. For the purposes of defining*

*and assessing compliance against the price-path, the Commission proposes to continue to use a form of 'notional revenue'.*

19. The ENA supports both of these points.

## **Possible s factor**

20. The Commission indicates it considers there is insufficient time to design and implement an “s” factor as part of the DPP determination to apply from April 2010 (paragraph 172). The ENA accepts this timing issue. However, the ENA recommends the Commission continues to lay a platform for an s factor in the future by:
- implementing a robust measurement method for service quality (discussed further below); and
  - committing to a project to develop an s factor, with a view to implementing it within the regulatory period. This will provide EDBs with an opportunity to be compensated for improvements in quality should they so choose. Importantly, it will also provide the certainty and clarity necessary to stimulate innovation in service quality delivery.

## **Re-openers**

21. The Commission indicates a provision for re-openers is unlikely to be feasible for the DPP for the period between April 2010 and whenever the further reset comes into force (paragraph 181). The Commission also suggests that a CPP may be a substitute for a DPP re-opener, and by implication appears to question whether the DPP requires re-openers.
22. 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). A CPP would be a poor and overly cumbersome mechanism for such events, and furthermore some of the restrictions the Commission is suggesting in relation to the timing of CPP applications would make their use impractical for such events.
23. The ENA is accepting that it may not be practical for timing reasons to incorporate re-openers in the DPP determination applicable from April 2010, but we consider it is important to craft into that determination the ability to incorporate re-openers as soon as the relevant input methodologies are published.

## Definition of quantities

24. The Commission proposes using a “notional revenue” calculation similar to that used for the thresholds to assess annual compliance with the price path. It is proposing to update the quantities in this calculation each year along the lines used in the gas authorisation (paragraphs 357 – 359). The ENA understands this would mean that each year the quantities on both sides of the compliance equation would be updated using quantity data from the prior year.
25. The ENA supports the use of the “notional revenue” calculation and the annual updating of quantities along the lines used in the gas authorisation. To ensure that compliance costs are minimised, the relevant quantities should pertain to the prior 31 March pricing year. This avoids difficulties with matching quantities to relevant prices, particularly for any EDB that restructures its prices.

## Pass-through costs

26. The Commission proposes to include the following cost items as 100% pass-through costs (paragraphs 201 – 205):
  - transmission charges, including avoided transmission charges.
  - local authority rates.
  - Commerce Commission and Electricity Commission levies.
27. The ENA supports these cost items being pass-through costs. We note and support the specific addition of Commerce Commission levies as pass through costs. We also note however that significant Commerce Commission levies will be incurred by EDBs in the 2009/10 assessment period, prior to the DPP reset and for which no recovery mechanism is available – the levies being announced after the 2009/10 prices were set. This levy will reflect the Commission’s costs not only in respect of the DPP Reset, but also the significant input methodology work stream. These input methodologies will apply for a seven year period. The Commerce Commission levy for the current year therefore will represent the unusually high consultation, design and implementation tasks that must be undertaken as a result of the Commerce Amendment Act. Accordingly we submit that the 2009/10 Commerce Commission levy should be amortised over the forthcoming regulatory period and included as a pass through cost for the purpose of the DPP to enable EDBs to be able to recover these extraordinary external costs.
28. In the case of transmission charges we submit that they should be passed through in full in the DPP. EDBs collectively are unable to control the total level of transmission charges in the short term however Part 4 provides the appropriate mechanism for this. We also note that the Transmission Pricing Methodology

(TPM) is complex and under review. It is therefore inappropriate to consider anything less than a 100% pass through in this context for the DPP.

29. Financial incentives to manage load should and can be provided for elsewhere in the DPP as previously noted. Over time these will contribute to efficiencies in transmission (and distribution) costs assuming investment in capacity is able to be deferred as a result.
30. In addition, the inclusion of transmission as a pass through, combined with the specification of the DPP using updated quantities (ie: on the basis that the quantities used to calculate Notional Revenue and Allowable Notional Revenue are to be those relating to the prior year) provides a low cost and simple solution to the transmission volume anomaly. This approach preserves the relationship between the quantities embodied in revenue and transmission pass through costs over time as both will mirror the trend in volume for each EDB, albeit the revenue quantities will be based on a 12 month lag.
31. We also recommend a quantity adjustment mechanism to compensate for energy efficiency measures as discussed above.
32. We also submit 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. A similar provision has been included in the gas authorisation. The process provided for in the gas authorisation is that the controlled business applies 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).

## **Excluded services**

33. Under the thresholds regime of Part 4A the scope of regulation was much broader than that of “electricity lines services” in Part 4 (see clause 54C), and that scope was defined in legislation with respect to the goods and services supplied by EDBs, as follows (clause 57 (1) of Part 4A):

*(1) The Commission may, by notice in the Gazette, declare that all or any goods or services supplied by a large electricity lines business in markets directly related to electricity distribution and transmission services are controlled.*

34. This approach to defining the scope of regulation meant the Commission needed to define in a Gazette notice those goods and services that were to be controlled. It did this by way of defining “specified services” in clause 3 of the Thresholds Gazette Notice,<sup>5</sup> as follows:

*specified services means, in relation to a lines business, all goods and services, provided in New Zealand, that are electricity distribution or transmission goods or services or are directly related to the provision of electricity distribution or transmission, and includes—*

*(a) the provision, operation, and maintenance of electricity works such as lines, cables and substations that facilitate the local or regional conveyance of electricity from embedded generators or the national grid to customers; and*

*(b) the provision, operation, and maintenance of electricity works such as the high voltage direct current inter-island link and lines, cables, and substations that facilitate the national conveyance of electricity throughout the national grid; and*

*(c) the sale of electricity conveyance services to electricity retailers or customers, —*

*but does not include—*

*(d) any goods and services described in paragraph (a), (b) or (c) if the lines business demonstrates beyond reasonable doubt that there is workable or effective competition for the provision of those goods and services; or*

*(e) non-conveyance goods and services, such as energy use monitoring services, consulting services, or the provision of information not directly related to the provision of electricity distribution or transmission, if the lines business demonstrates beyond reasonable doubt that those goods and services are not directly related to the provision of electricity distribution or transmission; or*

*(f) the provision of system operator services, if the lines business demonstrates beyond reasonable doubt that there is workable or effective competition for the provision of those services; or*

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<sup>5</sup> Commerce Act (Electricity Distribution Thresholds) Notice 2004

*(g) services for which loss and constraint rentals are paid, if the lines business demonstrates beyond reasonable doubt that amounts received for those services are passed on transparently and in full to its customers; or*

*(h) financial services related to transmission (known as “financial transmission rights”), if the lines business demonstrates beyond reasonable doubt that the amounts arising from settlement of those services are passed on transparently and in full to its customers; or*

*(i) in relation to a distribution business, connection, disconnection, or reconnection services, if the distribution business demonstrates beyond reasonable doubt that there is workable or effective competition for the provision of those services; or*

*(j) in relation to a distribution business, services provided in response to a contestable tender, if the relevant customers agree in writing that, and the distribution business demonstrates beyond reasonable doubt that, there is workable or effective competition for the provision of those services; or*

*(k) in relation to Transpower, goods and services provided under new investment contracts, if the other party agrees in writing that the terms and conditions are reasonable or reflect contestable provision of the goods and services; or*

*(l) in relation to Transpower, goods and services provided as a result of new investment if Transpower demonstrates beyond reasonable doubt that the new investment was approved under a process (whether regulatory or otherwise) that provides for affected customers to make and approve price-quality trade offs and opportunity for competitive provision of new investment by parties other than Transpower.*

35. This definition was framed in terms of services to be included and those to be excluded. This approach led to the concept of “excluded services” as discussed in paragraphs 206 & 207 of the Reset Paper. Under Part 4A an “excluded service” was not controlled.
36. 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 above of “specified services”.

37. 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:*

38. 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.
39. 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.
40. We note the above example is in contrast to a situation where a developer conducts a competitive bid process for the installation of an electricity network, but for which there is no long term contract for the supply of electricity lines services to the ongoing consumers (i.e. the purchasers of the sections from the developer). Thus the carve-out needs to be dependent on the consumer of the electricity lines service agreeing to it.
41. 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.

## **5. Starting prices**

### **Starting prices as from April 2010**

42. In relation to starting prices to apply as from 1 April 2010 the Commission states (paragraph 232):

*The Commission’s preliminary view is that starting prices for the Reset DPP for EDBs should be specified as those that applied at the end of the Initial DPP. The Commission considers that it is preferable that starting prices be the Actual Prices posted by each EDB as at 31 March 2010. From an implementation perspective the use of Actual Prices—as opposed to prices derived from the prior thresholds formula—is likely to be more transparent and provide for greater certainty.*

43. The ENA supports this approach to setting the DPP starting prices and note for the avoidance of doubt the price allowed in the twelve months to 31 March 2011 would be the actual prices effective at 31 March 2010 plus CPI-X plus any pass through cost adjustments.

## **Possible adjustment to starting prices**

44. The Commission proposes to undertake an assessment of “current and projected profitability” of EDBs subsequent to publishing input methodologies, and use that assessment to inform a possible adjustment of DPP starting prices (paragraphs 224 – 226). Any such adjustments would take effect from April, that is they would take effect at the commencement of a regulatory year.
45. The ENA supports the timing of any such possible price adjustments, in that this approach results in only one possible adjustment, is sequenced to follow the publication of input methodologies, and would take effect at the commencement of a regulatory year.
46. The Commission proposes methods to measure “current and projected profitability”, to compare those measurements with an estimate of an EDB’s WACC, and then use that comparison to inform any adjustment to an EDB’s starting prices (paragraphs 234 – 283).
47. The methods the Commission is proposing would be new to the regulation of electricity lines services in New Zealand as they do not have an analogue in the thresholds regime. Furthermore, they reflect judgments about the expected relationship between an ex ante WACC estimate and an ex post ROI measure, and the incentive effects of adjusting an EDB’s prices in response to the level of its current and projected ROIs.
48. Given the importance of these methods to EDBs’ long term profitability, their potential incentive effects, and that they are untested, the ENA has decided to submit on this topic in more detail in response to the Input Methodology Discussion Paper. This is appropriate as it is interrelated with the options for deriving a WACC estimate and the building block components of ROI.

49. We do however wish to raise a sequencing issue that appears to be problematic with the Commission’s proposal. It appears that the Commission proposes to incorporate into the DPP determination (to be completed in November) the methods to adjust starting prices. However, at that time input methodologies will not have been published. This sequencing would require EDBs to take final views on these methods, and the Commission to make decisions on them, without knowing the input methodologies that will determine many of the elements that feed into the methods. For example, at November it will not be clear as to whether an EDB’s RAB will be indexed or not, what common cost allocation methods will be used, or how regulatory tax will be calculated. In our view it will not be possible therefore to test these proposals with any confidence in the absence of final input methodologies.
50. On the other hand, it is important to know with certainty, as early as possible, how these price adjustments will be made. One way to reconcile these tensions would be to set out in the DPP determination the process the Commission will follow to determine the methods it will use to make these possible price adjustments. For example, this process could be a commitment, once input methodologies have been published, to consult on the method to make these possible price adjustments, and to confirm those methods prior to applying them. This approach would not preclude doing further work on these methods in the interim, but it would ensure final views and decisions on them would be deferred until after the input methodologies are confirmed.

## **Possible application of claw-back**

51. The Commission proposes that any claw-back, in the context of an adjustment to starting prices, should be “*well specified if it is to be used and only applied in exceptional circumstances*” (paragraph 289).
52. The ENA supports this approach. As mentioned above in relation to the methods to making any price adjustments, it will not be feasible to finalise the specification of claw-back and what is “exceptional” until after the input methodologies have been published.

## **6. Rates of changes**

### **Use of CPI – X indexing**

53. The Commission proposes:
- using a CPI – X mechanism to index the price path under the DPP (paragraph 304).
  - use of a lagged CPI by, for example, six months (paragraphs 361 – 365).

54. The ENA supports the use of the CPI - X mechanism. The ENA however supports the use of a forecast CPI option (paragraph 366) rather than the alternative six month lag proposed. If this were made available to EDBs prior to when prices are set then the same CPI could be incorporated into price setting as used in DPP assessments.
55. It will be appropriate to allow an adjustment in each following year for the difference between the forecast CPI and actual CPI in the DPP. This is a simple equation and provides for a fair adjustment (either positive or negative) for the difference between actual and forecast CPI for the prior assessment period.

## **Development of Enforcement Guidelines**

56. The Commission proposes developing Enforcement Guidelines, “*to give suppliers greater certainty about the steps proposed for compliance and enforcement matters arising from Part 4 of the Act*” (paragraph 382).
57. 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. This is necessary to promote regulatory certainty and transparency.

## **Use of TFP analysis to set X**

58. In relation to using total factor productivity (TFP) analysis to set “X”, the Commission states (paragraph 314):

*As discussed above, the Commission’s preliminary view is that the productivity analysis used to inform the setting of the X-factor under the Reset DPP should be based on TFP. It considers that the implementation of TFP used to derive the B-factor should form the basis of this analysis. However, the Commission acknowledges that there were a number of methodological issues with the implementation of the B-factor under the thresholds regime. As such, and having considered relevant submissions on the issue, the Commission proposes introducing a number of refinements to the methodology to be used under the DPP. These are discussed in the next section.*

59. The Commission circulated two papers from Economic Insights that traverse a range of issues related to the design of regulation, the design of TFP as part of regulatory price setting, and implications for other aspects of a regulatory regime (e.g. for valuation methodology).

60. We are concerned with the direction the Commission is taking with regard to the development of TFP analysis. The Economic Insights material appears to us to be more suited to academic research than to the task at hand. Previous attempts used by the Commission to use TFP analysis to inform the setting of C1 and C2 factors have lacked credibility and in practice produced very volatile results (i.e. EDBs shifting from one end of the rankings to the other). These experiences are salutary lessons as to the importance of not using experimental methods to undertake this work, and the Economic Insights' conclusions would once again be experimental (as far as we are aware their proposed methods have not been implemented elsewhere).
61. In addition we submit that the TFP proposals contained in the Reset Paper and associated papers are presented in a manner which is not suitable for consultation purposes. EDBs are unable to effectively respond to the proposals because there is insufficient information provided to assess the impact of them.
62. Accordingly to assist EDBs to understand the proposals and in order to assist in a tangible way to progress the Commission's thinking and options in relation to TFP, we have engaged Pacific Economic Group (PEG). PEG is to provide an approach to TFP that has been used and tested in other jurisdictions, and to test the application of this method in the New Zealand context with New Zealand data. We intend to submit this material by 31 July and will be seeking direct engagement with the Commission to arrive at a fair and practicable TFP approach.

## 7. Quality standards

63. In relation to quality standards the Commission states (paragraph X22):

*The Commission considers it appropriate to use the premise of 'no material deterioration' in service quality, and use SAIDI and SAIFI reliability measures, to set and assess quality performance.*

64. The ENA supports these two starting propositions for determining quality standards.
65. The Commission also develops in some detail various ways in which to measure these reliability measures, to take account of extreme events and natural variation in the data. The ENA supports in general terms the direction in which the Commission is developing these issues. The ENA has a project underway to develop statistically robust approaches to the measurement of SAIDI and SAIFI in New Zealand and appreciates the ongoing engagement to date with Commission staff on this project. The next stage of results from this work will inform our more detailed submission on these issues, plus we wish to discuss

these with ENA members on 28 July, prior to submitting them to the Commission. Thus we intend to submit on this topic in more detail by 31 July.

## Appendix – Answers to questions

<p><b>1. How might genuine innovations be rewarded under a DPP? Please explain</b></p> <p>By providing for incentive mechanisms in the specification of the DPP as proposed in Section 3 and Section 4 of our submission.</p>
<p><b>2. Are there any other economic principles you believe are relevant to the DPP reset? If so, please explain</b></p> <p>The economic principles must be considered alongside the implementation principles of flexibility, transparency, cost effectiveness and consistency and the overall objective of promoting regulatory certainty.</p>
<p><b>3. What are your views on the Commission’s proposal to have a single section 52P determination, which specifies requirements for each EDB?</b></p> <p>Agree but as noted in paragraph 8 provision should be provided for the implementation of future incentive mechanisms where the implementation details are not able to be developed by the DPP Determination date.</p>
<p><b>4. What are your views on the timeframes relevant to the DPP reset?</b></p> <p>Given the additional complexity that is proposed to be included in the DPP (for example the rolling forward of quantities and the normalisation of quality for extreme events) it is not appropriate to retain the same 35 working day requirement for the publication of audited compliance statements. 50 working days is more appropriate particularly as the compliance period falls at the same time as the financial year end for most EDBs and impacts on the availability of staff and auditors.</p> <p>We also urge the Commission to publish the draft Gazette Notice of the Determination as early as possible, prior to mid November. This first draft may exclude the specific price-quality paths for each EDB, but it will allow sufficient consideration of the phrasing and formula and the definitions of each of the key components of the DPP, along with proposed compliance requirements (such as the form of auditors reports). The two week consultation period currently provided for is insufficient, and as demonstrated in 2004, is likely to result in subsequent amendments if errors or additional explanations are required to be addressed.</p>
<p><b>5. Are there any other relevant timeframes that should be included in a Determination, but have not been discussed in this paper?</b></p> <p>The DPP determination should include timeframes within which the Commission will respond to a breach of the DPP. This may include an initial response period, and also the period by which a final decision on a recommendation will be made. This would promote regulatory certainty and address one of the major concerns with the previous thresholds regime.</p>
<p><b>6. What are your views on the proposed additional content of a Determination set out above? Are there additional matters that should be considered for inclusion?</b></p> <p>Additional guidance should be included in the determination as to what explanatory information the Commission wishes to receive regarding breaches. This will facilitate post breach processes.</p>

- 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?**

Refer Section 3 (paragraphs 13-17) for our views on the proposals for meeting the section 54Q requirements and our alternative suggestions in this respect.

- 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.**

Refer Section 4 (paragraphs 28 and 32) for our views on provision of allowances for new legislative requirements and the TPM.

- 9. What are your views on the appropriate methods for analysing current and projected profitability?**
- 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?**
- 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.**
- 12. Do you consider that a time series of cost data may provide more helpful contextual information when assessing current profitability than a single year’s data? If a single year’s data were to be used, is it appropriate to consider the latest available data received under information disclosure, which is likely to relate to the financial year preceding the adjustment? Please explain.**

Refer Section 5 (paragraphs 44-50) for our views on possible adjustments to starting prices.

- 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?**

Refer Section 4 (paragraph 20) for our views on the development of a possible s factor mechanism to more closely link the price and quality components of the DPP

- 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?**

Refer Section 4 (paragraphs 21-23) for our views on re-openers within the DPP.

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

Refer Section 4 (paragraphs 18-19) and Section 5 (paragraphs 42-43) for our views on the prices and notional revenue to be included in the DPP.

<p><b>17. What are your views on the proposed pass-through costs including the incorporation of Commerce Commission levies?</b></p> <p><b>18. To what extent do you consider transmission charges to be outside the control of EDBs?</b></p> <p>Refer Section 4 (paragraph 27) for our views on Commerce Commission levies as pass through costs.</p> <p>Refer Section 4 (paragraphs 28-30) for our views on transmission charges as pass through costs.</p>
<p><b>19. Are the Commission's proposed definition of price and the associated definition of excluded services appropriate? If not, please explain</b></p> <p>Refer Section 4 (paragraphs 33-41) for our views of the definition of excluded services in the context of the DPP.</p>
<p><b>20. What options might there be for the promotion of energy efficiency through the specification of starting prices?</b></p> <p>Refer Section 3 (paragraph 16) for our views on energy efficiency incentives consistent with the specification of starting prices.</p>
<p><b>21. Given the generic nature of the X-factor, to what extent might it be necessary to make starting price adjustments, based on EDBs' specific circumstances?</b></p> <p><b>22. What are your views on whether it is appropriate for starting price adjustments to be deferred until after input methodologies determinations are published? Do you foresee any issues that may affect the Commission's ability to do so? Please explain</b></p> <p><b>23. What are your views on the indicative timings in Table 4, including the date when the adjustment takes effect (i.e., 1 April 2011)?</b></p> <p>Refer Section 5 (paragraphs 44-50) for our views on starting price adjustments under the DPP.</p>
<p><b>24. What are your views on whether starting prices should be specified in terms of Actual Prices? How should these prices be specified (e.g., in terms of prices for distribution services, net of pass-through costs, etc)?</b></p> <p>Refer Section 5 (paragraphs 42-43) for our views on appropriate starting prices for the DPP reset.</p>

25. What are your views on the WACC measure appropriate for comparing with a ROI in assessments of current profitability?
26. Do you consider that a time series of cost data may provide more helpful contextual information when assessing current profitability than a single year's data? If a single year's data were to be used, is it appropriate to consider the latest available data received under information disclosure, which is likely to relate to the financial year preceding the adjustment? Please explain
27. How do you consider a time series of cost data could inform the assessment of current profitability?
28. In considering the current profitability of an EDB, is it appropriate to use a partial building blocks approach to estimate its current ROI? What are your views on Formula 2 above in this respect
29. What are your views on the Commission estimating an industry-wide WACC using historical data to inform current profitability assessments?
30. What are your views on whether an industry-wide WACC should be used to inform projected profitability?
31. What are your views regarding a quantitative returns-based assessment of projected profitability under the DPP?
32. What are your views on the Commission's proposed approach for assessing projected profitability to inform its adjustments of starting prices?
33. What other options do you consider there are for assessing projected profitability?
34. What type of scenarios do you consider are likely to impact on an EDB's projected profitability that could be defined in advance and taken into account when adjusting starting prices?
35. What time period should assessments of projected profitability cover e.g. should these assessments consider periods beyond the applicable regulatory period?
36. What are your views on the proposed two-step approach to calculating starting price adjustments?
37. What are your views on whether a quantitative returns-band approach should be used reflecting the possible inter-temporal imprecision from partial building blocks analysis? How should such a returns-band be defined (e.g., as an absolute or relative amount to the WACC point estimate)? How should starting price adjustments reflect an EDB's position relative to the upper and lower bounds?
38. What are your views on whether a qualitative scenario-based mechanism should be used to inform the starting price adjustment? What characteristics should be considered in determining appropriate scenarios and how should their magnitude be defined?
39. How should EDBs that are likely to face scenarios affecting projected profitability be treated? Should adjustments be made to their returns-band? If so, how should this be done?

Refer Section 5 (paragraphs 44-50) for our views on possible starting price adjustments for the DPP.

40. What circumstances might constitute financial hardship for an EDB or price shocks to consumers? Which circumstances, if any, warrant the use of a glide-path?
41. Under what circumstances do you consider it would be appropriate for the Commission to apply claw-back?
42. How should claw-back be applied? Should it be done as an additional P0 adjustment or using a glide-path?

Refer Section 5 (paragraphs 51-52) for our views on the possible application of claw back in the DPP. Also refer to our earlier submission on this matter<sup>6</sup>.

43. To what extent will a recessionary economic climate impact differently on the productivity of EDBs and the economy as a whole?
44. What are your views on the potential promotion of energy efficiency through the setting of the X-factor?
45. How might international productivity data be used as a check for the reasonableness of results based on New Zealand data? Do you have any views on the likely sources of appropriate data (e.g., by jurisdiction or overseas regulators)?
46. What are your views on the amended TFP formula? What are your views on the proposed practical application?
47. What are your views on potential use of IHC, rather than ODV in the TFP analysis? Do you agree that the 2004 ODV is the best starting point for an electricity distribution IHC series? If not, what alternative starting point should be used?
48. What are your views on an appropriate method of forming an IHC time series? How should this be achieved?
49. Do you agree that transformer capacity, as well as line capacity, should be recognised in a measure of system capacity? Do you agree with the measure proposed to incorporate both transformer capacity and line capacity in the system capacity output?
50. What are your views on forming a system capacity output measure, taking account of the need for such a measure to be relatively simple and easy to construct?
51. What are your initial views on whether an approach that accounts for sunk costs might effectively implement the input price differential?
52. How should the Commission estimate capital expenditure for the forthcoming regulatory period in a cost effective manner?

Refer Section 6 (paragraphs 58 – 62) for our views on the proposed productivity analysis to set the X factor for the DPP, in particular our engagement of PEG to provide expert input on this complex issue.

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?

Refer Section 4 (paragraphs 24 – 25) for our views on the appropriate base quantities for the DPP.

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<sup>6</sup> *Potential Reset of the DPP and Claw-back Subsequent to Publishing Input Methodologies*, 18 May 2009, Electricity Networks Association

**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?**

**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?**

Refer Section 6 (paragraphs 53-55) for our views on the appropriate CPI for the DPP.

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

Refer Section 4 (paragraph 27) for our views on Commerce Commission levies as pass through costs.

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

**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?**

**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?**

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

Refer Section 4 (paragraphs 28-30) for our views on transmission charges as pass through costs.

**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**

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

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

**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?**

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

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

Consulting with customers over quality standards is an activity which is addressed in asset management planning and demonstrated via AMPs disclosed under information disclosure regulation. This is the appropriate regulatory mechanism for this purpose

Refer Section 7 (paragraphs 63-65) for our view on the specification of quality for the DPP reset.

Also refer Section 4 (paragraph 20) for our views on a possible s factor mechanism to provide opportunities for EDBs to invest in improvements in quality.

67. What are your views on the use of a five-year historic average as the basis for quality standards under the DPP? Do you have any comments on the potential for quality standards to be based on a moving five-year historic average?
68. What are your views on the proposal to include 2008/09 non-normalised daily outage data?
69. What are your views on the appropriateness of the IEEE 2.5 Beta Method for identifying extreme variability in quality data?
70. What are your views regarding any other appropriate methods for identifying extreme variability that could be implemented under DPP reset?
71. Do you agree that dead-bands are an appropriate statistical method for accounting for the effects of normal variability in order to identify material deteriorations in quality? If not, please explain
72. What are your views as to appropriate methods for calculating the size of the dead-band?
73. How appropriate is the potential use of a three-year moving average scheme, as described above? Is three years an appropriate timeframe? Would such a scheme impact incentives related to the timing of planned maintenance?
74. What are your views on whether a multi-year assessment, as described above, is appropriate under a DPP? What, if any, potential problems do you see with adopting this type of mechanism?
75. What are your views on the incentives for EDBs with respect to quality performance given that a breach can only occur when an EDB's quality performance does not meet the required standard for two out of any three years?
76. What are your views on the Commission's proposed approach for assessing quality standards under the Reset DPP?

Refer Section 7 (paragraphs 63-65) and in particular reference to the ENA's ongoing project to develop statistically robust approaches to measurement of SAIDI and SAIFI in New Zealand for the purpose of the DPP.