

15 April 2009

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Dear David

RE: Reset of Default Price –Quality Path for Electricity Distribution Businesses

Auckland Energy Consumer Trust (AECT) welcomes this opportunity to respond to the recent *Process and Issues Paper*¹ (Process Paper) released by the Commerce Commission (Commission). The purpose of this letter is to provide AECT's views on the Process Paper.

Summary of AECT's Submission

The primary concern addressed in our submission is that the Commission's proposed treatment of *starting prices* (albeit as an *initial view*) introduces further uncertainty for an extended period. AECT values regulatory certainty, and submits that existing prices should be rolled over as the starting prices for the 2010 Default Price Path (DPP) without any claw-back in the future. Some of our other concerns in relation to the Process Paper are:

- Reset Process

The Commission proposes a three stage consultative process for resetting the DPP by 1 December 2009 – even though the DPP itself does not come into effect until 1 April 2010.

➤ *AECT supports the Commission's proposed reset process – but would appreciate the more timely release of 'decision' material to aid effective consultation.*

- Reset Issues

The Commission has considerable discretion in the setting of reset parameters (including the starting prices). This discretion must be guided by the 'new' legislative² purpose/intent.

➤ *Resetting the DPP should be consistent with the statutory purpose of providing more certain and lower cost regulatory outcomes with accompanying incentives to invest.*

- The Commission's 'Initial View' on the Reset

¹ Commerce Commission; "Reset of Default Price-quality Path for Electricity Distribution Businesses: Process and Issues Paper"; 30 March 2009

² unless otherwise stated, references to 'Act', 'legislation' or 'statute' are references to the Commerce Act 1986 (following the enacting of the Commerce Amendment Act 2008)

The Commission's initial view is that the CPI-X price path may be progressively reset. The first step is for a new X-factor, and revised quality parameters to apply from 1 April 2010. The second step is to effect P_0 adjustments (based on current/future profitability) and claw-backs following the determination of input methodologies on (or after) 30 June 2010.

➤ *AECT does not support the 'two-step' approach suggested as an initial view by the Commission.*

- AECT's Consideration of the Right Approach

The Discussion Stage should consider other options for resetting *starting prices* under the DPP – in particular reset options without P_0 adjustments/claw-back as this provides greater regulatory certainty and (arguably) greater consistency with the statutory purpose. In addition, options (including legislative changes) for shortening the regulatory period (commencing 1 April 2010) may be examined.

➤ *AECT submits that existing prices should be rolled over as the starting prices for the 2010 DPP without any claw-back in the future.*

AECT's Submission

Introduction

The Commission's Process Paper on the DPP has sections dealing with the reset process, reset issues, and with the Commission's initial views on the reset. These, together with AECT's considerations, are discussed below.

1. The Reset Process

The process as outlined in the Process Paper involves three *fairly brief* stages (over the period from May to late November 2009):

- a. Discussion Stage – where the Commission provides its preliminary views and consults with interested parties
- b. Decision Stage – where the Commission issues its draft decisions, and following submissions and cross submissions from interested parties, issues its final decisions
- c. Drafting Stage – the preparation and Gazettal of the reset determination.

<p>Given the tight timeframes, AECT supports the Commission's (above) process for the 2010 reset. However, AECT would encourage more 'decision' material being released sooner (and perhaps in parts) to ensure more effective consultation.</p>

2. Reset Issues

As you are aware, for the 2010 reset the DPP must be Gazetted by 1 December 2009. Input methodologies for electricity lines services, however, are not required to be determined until 30 June 2010 (at the earliest). The Commission will not be able to rely on 'determined' input methodologies to guide the setting of DPP parameters.

Under the Act, the Commission has discretion as to whether it should:

- adopt existing prices as the starting prices for the reset, or set new starting prices via a P_0 adjustment in the absence of 'determined' input methodologies; and
- apply a claw-back following the determination of input methodologies.

As the Act does not provide any explicit guidance on how the Commission should exercise its discretion, AECT believes that the purpose/intent of the legislation should be used as guidance. AECT notes that the passage of the Commerce Amendment Bill into law last year was heralded as follows:

*"The passing of this Bill is excellent news for the growth and improvement of New Zealand infrastructure businesses that are natural monopolies. It will provide greater certainty for regulated businesses and incentives for investing in infrastructure while giving consumers protection from excessive prices and poor quality ... Overall, most regulated businesses should face lower compliance costs because of greater certainty about the rules and better designed regulatory processes."*³

The resetting of the DPP should provide more certain, and lower cost regulatory outcomes – with accompanying incentives to invest.

3. The Commission's 'Initial View' on the Reset

As you are aware, the Commission has provided its initial view as to how the reset of the DPP may occur, and how it may exercise its discretion. For instance, on 1 April 2010:

- The price-quality path would be reset to include a new X parameter (for CPI-X), starting prices, and new quality standards;
- X would be based on total factor productivity – in the way the B-factor for the *threshold* price path was set;
- Starting prices would be those prices applying at the end of the initial DPP (i.e. prices applying at 31 March 2010);
- Quality would reference SAIDA and SAIFI metrics in a manner that indicates any underlying deterioration in reliability.

Subsequently (i.e. within 9 months after Input Methodologies are determined)

- Starting prices for 1 April 2010 would be re-determined, and a claw-back would be applied.

AECT appreciates that the *transitional arrangement* that requires the Commission to reset the DPP in 2010 prior to input methodologies being determined is an issue of considerable concern to the Commission and AECT alike. The Commission has sought to address this issue in its initial view. However, AECT is concerned with the proposed two step process, and in particular with the potential claw-back – which will project considerable uncertainty beyond the determination of input methodologies. However, AECT acknowledges that the Commission's initial view does not represent a fully considered position.

The following table sets out the range of reset options for the DPP. The question is which reset option best achieves the aforementioned reform objectives.

³ Press Release "Infrastructure investment gets boost from law changes" – Lianne Dalziel, Minister of Commerce, 5 September 2008

		From determination of Input Methodologies (post 1 July 2010)	
		P ₀ / Claw-back	No Claw-back
From 1 April 2010	Existing Prices	<ul style="list-style-type: none"> • Supports Allocative Efficiency • Uncertain outcomes • High Compliance Cost DPP (Commission's Initial View) 	<ul style="list-style-type: none"> • Provides Certainty • Provides Investment Incentives • Low Compliance Cost DPP (AECT's Preferred Option)
	P ₀ *	<ul style="list-style-type: none"> • Inefficient • Uncertain outcomes • Very High Cost DPP (Not a Practical Option) 	<ul style="list-style-type: none"> • Uncertain outcomes • Inconsistent with future DPP resets

* P₀ not necessarily based on input methodologies

** In practice, prices are unlikely to be reset before 1/4/2012

AECT contends that the two-step approach espoused by the Commission in its initial view is more consistent with promoting allocative efficiency rather than promoting certainty, investment incentives, and low cost DPP regulation.

AECT does not support the 'two-step' approach suggested as an *initial view* by the Commission.

AECT expects that the Discussion Stage will provide a more comprehensive discussion of the right approach to:

- setting starting prices and other parameters to apply on 1 April 2010; and
- applying a claw-back following the determination of input methodologies.

At this time, AECT will provide further comment.

4. AECT's Consideration of the Right Approach

AECT has been involved in the development of the regulatory regimes for electricity and gas in New Zealand for some time now. It is a significant investor in such regulated infrastructure assets. A fundamental concern for AECT has always been to foster greater regulatory certainty as this provides the confidence to invest. It has been shown that regulatory uncertainty in the past has had a significant impact on the value of Vector and on incentives to invest. The Commission's initial views – which propose adopting existing prices as the *starting prices* for the reset and then apply a P₀ adjustment / claw-back following the determination of input methodologies – has the effect of creating a drawn out period of uncertainty which further undermines investment.

From AECT's perspective, the treatment of *starting prices* is the element of the DPP that potentially causes the most uncertainty. For this reason, AECT focuses on setting *starting prices* for the reset.

For the 2010 reset, AECT favours the Commission rolling over prevailing prices (i.e. the prices applying at the end of the initial DPP), as it would be inappropriate to translate 'profitability adjustments' to 'P₀ adjustments' without having determined key input methodologies – including: rates of return / WACC; efficiency carry-over incentives; and, asset valuation. This approach is consistent with providing regulatory certainty, and is also consistent with previous submissions from AECT and Vector – for example:

*"For the AECT, the key uncertainties include ... [t]he timing for setting the default price/quality path for electricity seems out of sequence with completing the input methodology process. In particular, this means that Vector (and others) will be subject to a price/quality path that may be set without reference to all input methodologies."*⁴

"Vector would also like to stress the need for co-ordination between the price path and input methodology work streams. ... given the timeframes involved in developing price paths, input methods and coming to grips with the impacts of financial markets and economic crises, the Commission should keep deferral options under

⁴ AECT; "Submission to Commerce Commission on the Regulatory Provisions of the Commerce Act 1986"; 16 February 2009; p10

review.”⁵

AECT supports the Commission’s initial view that the 1 April 2010 starting prices should be the prices applying at the end of the initial DPP.

AECT does not, however, favour the claw-back approach adopted by the Commission in its initial view. As argued previously, AECT considers that it is more consistent with the parliamentary intent to defer price adjustments until the next regulatory period, as:

- the intent of the DPP is to provide a low-cost regulatory option. The Commission is expected to exercise *latitude* in identifying current/future profitability, as an exhaustive ‘building blocks’ process is not warranted. For instance:

*“As the default price path is intended to be a low cost approach to setting the allowed price path, default price paths should be less information intensive than customised price paths. In particular, it would not be appropriate to require detailed forecasts of profitability to set the default price path ...”*⁶

- a claw-back will not be a low-cost regulatory option for the DPP (in fact, it may result in doubling-up the process), does not provide for regulatory certainty, and may undermine investment. For instance:

*“Although the Commission has the option of applying claw-back ... to remedy differences between assumptions underlying the default price-quality path and finally determined input methodologies, claw-back creates uncertainty, disruption and additional costs for business and is hence a far inferior approach to coordinating work streams in the first place.”*⁷

- prices have been subject to price-path regulation since 2001. This regulation has limited EDB profits, ensured no deterioration in quality, and has encouraged efficiency improvements which have been shared with consumers through past X-factors. Furthermore, parliament did not see any reason to adjust prices from 1 April 2009.
- a claw-back is not a practical option. Given commitments between EDBs and electricity retailers, any claw-back is unlikely to result in price adjustments before 1 April 2012.

AECT submits that existing prices should be rolled over as the starting prices for the 2010 DPP without any claw-back in the future.

This approach to the 2010 reset would avoid the uncertainty, disruption and additional costs for business that are a consequence of claw-backs. In subsequent resets, input methodologies will be known in advance, and future DPPs can be set robustly from the outset. AECT sees no reason for *initial price adjustments* not to be part of the regulatory toolkit in the future.

An alternative approach is to roll over existing prices for a two year period (without claw-back). This is in recognition that input methodologies are likely to be determined in the first (or second) year of the reset regulatory period. Ideally, starting prices for a new regulatory period can be determined without delay, and consistent with input methodologies ... but without the uncertainty of a potential claw-back. In suggesting this alternative, AECT is aware that a (relatively simple) legislative change would be required. However, if this is an option that the Commission is prepared to take up as part of the reset process, AECT would support the Commission’s endeavours to give effect to this.

As always, the AECT would be more than happy to meet with the Commission to discuss the concerns and/or the Trust’s strong desire for regulatory certainty as outlined in this submission.

Yours sincerely

⁵ Vector; “Regulatory Provisions of the Commerce Act 1986 – Response to Discussion Paper”; 16 February 2009; paras 123-124

⁶ *ibid*

⁷ *ibid* para 123

Auckland Energy Consumer Trust

A handwritten signature in black ink, appearing to read "Wameg Kru", is written over a horizontal line.

Chairman