

# **Default/customised Price-quality Regulation**

## **Reset of Default Price-quality Path for Electricity Distribution Businesses**

### **Process and Issues Paper**

*30 March 2009*



COMMERCE COMMISSION

Networks Performance Branch

Commerce Commission

Wellington

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## Purpose

- 1 This paper (“Process Paper”) outlines the proposed process the Commission intends to follow in resetting the initial default price-quality path (“DPP”) for Electricity Distribution Businesses (“EDBs”). The Process Paper also provides the Commission’s initial view on a number of issues relevant to the DPP.
- 2 The Commission invites submissions on both the proposed process and the initial views expressed in the paper. The Commission will reflect its consideration of submissions in a Discussion Paper proposed for publication in May 2009.

## Introduction

- 3 From 1 April 2009, suppliers of electricity lines services are subject to default/customised price-quality regulation under subpart 9 of Part 4 of the *Commerce Act 1986* (“the Act”), as amended by the *Commerce Amendment Act 2008*. Default/customised price-quality regulation replaces the Part 4A thresholds that applied to EDBs.
- 4 Under section 54G(2) of the Act, EDBs that do not meet the consumer-ownership criteria set out in section 54D of the Act are subject to default/customised price-quality regulation. The remainder of this paper will refer to EDBs that have not met the section 54D criteria as “non-exempt EDBs”.
- 5 The main features of default/customised price-quality regulation, include:
  - a DPP, a default set of regulatory provisions, which applies to non-exempt EDBs. The DPP is set in a “relatively low cost way” (section 53K) using readily available information;
  - the ability for individual suppliers to make proposals to the Commission for a customised price-quality path (“CPP”), which propose alternative price and/or quality paths to the DPP that better meet the supplier’s particular circumstances; and
  - penalty provisions for breaches of price-quality paths.
- 6 On 19 December 2008, the Commission released its *Regulatory Provisions of the Commerce Act 1986 - Discussion Paper* (“December Discussion Paper”). It set out the Commission’s initial views on the Commission’s proposed approach to implementing the new regulatory provisions. Submissions have been posted on the Commission’s website<sup>1</sup>. A number of these submissions raised concerns about the tight timeframes necessitated by the statutory deadline for the reset of the DPP and requested that the scope and timing of the reset process be developed to account for this.

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<sup>1</sup> <http://www.comcom.govt.nz/IndustryRegulation/regulatoryprovisionsofthecommercea.aspx>.

## **Timing of the DPP Reset**

- 7 Transitional arrangements apply for the period 1 April 2009 to 31 March 2010. During this period, the thresholds that expire on 31 March 2009 are deemed to be the initial DPP and the existing threshold levels and formulae will remain the same during that period, i.e., the same X-factors and quality threshold will continue to apply to non-exempt EDBs.
- 8 The timing of the DPP reset must fulfil the Commission's statutory obligations under section 54K(1), which provides that "before 1 April 2010, the Commission must reset the default price-quality paths". A summary of the section 52P determination ("Determination") that resets the DPP must be published in the Gazette at least 4 months before that DPP is to apply (i.e., the summary must be published by 1 December 2009).

## **Dialogue with EDBs**

- 9 The Commission has considered submissions requesting additional dialogue with the Commission to supplement the formal consultation process. The Commission is open to receiving proposals for additional interaction<sup>2</sup> with stakeholders in relation to the DPP reset. The Commission notes that any such dialogue with EDBs will not replace the need for, and role of, the formal consultation process.

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<sup>2</sup> The Commission notes work being undertaken by the ENA to investigate statistical variability in reliability performance and looks forward to discussing relevant findings in due course.

## Outline of DPP Reset Process

- 10 This section describes the key project stages. Each project stage will contain progressively more detail on the proposed DPP and seek to address and draw conclusions on particular issues as the project proceeds. The Commission envisages that the DPP reset process will consist of three stages, each with a significant consultative element. These stages are as follows:
- i. discussion stage;
  - ii. decision stage; and
  - iii. drafting stage.
- 11 The three outputs for the DPP reset process are:
- a Determination, setting out how the DPP applies to EDBs from 1 April 2010;
  - a Decisions Paper that outlines how decisions relating to the Determination were made; and
  - a summary of the Determination, published in the Gazette by 1 December 2009.

### *Discussion Stage*

- 12 This Process Paper marks the beginning of the discussion stage and reflects the Commission's intended process to reset the DPP. This paper is subject to a two-week consultation process, which seeks the views of interested parties.
- 13 Following this Process Paper will be a "Discussion Paper", setting out the Commission's preliminary views on the DPP and how it should be determined. Views received on the Process Paper will be incorporated into the Discussion Paper. The Discussion Paper will cover issues such as:
- *Overall Form and Scope of the DPP*: a proposal on the likely form of the DPP and a proposed approach to consumer-owned EDBs;
  - *Starting Prices*: preliminary views on starting prices that apply on 1 April 2010;
  - *Rates of Change*: preliminary views on the methodology for calculating the rate of change 'X', including any specific treatment of inflation; and
  - *Quality Standards*: preliminary views on the methodology for determining appropriate quality standards and assessing EDB performance.
- 14 Consultation with interested parties will follow the release of the Discussion Paper, inviting written submissions from interested parties over a six week period.

*Decision Stage*

- 15 In the decision stage, the Commission will consider submissions on the Discussion Paper and prepare and consult on a draft “Decisions Paper”. The paper will include initial decisions such as:
- *Overall Form*: the proposed form of the DPP and its constituent elements;
  - *Starting Prices*: proposed starting prices for non-exempt EDBs;
  - *Rates of Change*: proposed rates of change for non-exempt EDBs, including any alternative rates for particular businesses; and
  - *Quality Standards*: proposed quality standards for EDBs.
- 16 Consultation with interested parties will follow the release of the draft Decisions Paper, inviting written submissions from interested parties over a six week period. Following the publication of submissions on its website, the Commission will invite cross-submissions over a two week period. A final Decisions Paper specifying, at a minimum the items set out in section 53O, will be published following consideration of submissions and cross-submissions. A brief consultation (one week) on the final Decisions Paper may be held to allow EDBs to confirm their final proposed DPP.

*Drafting Stage*

- 17 The Commission will prepare a draft Determination during the drafting stage and consult, over a two week period, on its form and content. Following consideration of submissions, the Commission will publish the final Determination and a summary of the Determination in the *New Zealand Gazette*. Development and consultation on the draft Determination will take place in parallel with the finalisation of the DPP.

**Indicative Timetable**

- 18 The table below summarises the main consultative steps the Commission intends to follow, as far as possible, when resetting the DPP. Milestone dates are indicative and may vary.

Stage	Key Step	Indicative Date
Discussion	Publish Process Paper	Late March 2009
	Publish Discussion Paper	May 2009
Decision	Publish draft Decisions Paper	September 2009
	Cross-submissions	Late October 2009
	Publish final Decisions Paper	Mid November 2009
	Short consultation on final DPP levels	Mid November 2009
Drafting	Publish draft Determination	November 2009
	Publish Determination and <i>Gazette</i> summary of Determination	Late November 2009

## Commission's Initial Views

- 19 Having considered submissions to the December Discussion Paper, the Commission continues to consider issues relating to the EDB DPP Determination. While no preliminary decisions have been made, the Commission is of the view that a number of issues raised and consulted on as part of the suspended 2009 thresholds reset process are, to varying degrees, relevant to the development of the DPP. This previous work may be drawn upon in developing the DPP. In addition, the Commission considers it appropriate to include a number of initial views in this Process Paper having considered submissions to the December Discussion Paper. The Process Paper only contains the Commission's initial views. The Commission has not made any decisions on matters relevant to the development of DPP.

## Rates of Change

- 20 The Act specifies that rates of change for EDBs under a DPP are to be:

*based on the long-run average productivity improvement rate achieved by either or both of suppliers in New Zealand, and suppliers in other comparable countries, of the relevant goods or services, using whatever measures of productivity the Commission considers appropriate.*

- 21 Section 53P(6) provides for the Commission to use "whatever measures of productivity [it] considers appropriate" to set the rates of change. Both the Commission and EDBs have had experience with the use of Total Factor Productivity ("TFP") analysis to measure productivity improvements rates. Use of TFP to inform the setting of rates of change is likely to promote the section 53K objective to develop a relatively low cost DPP mechanism. The December Discussion Paper suggested that the provisions relating to rates of change suggested a CPI-X mechanism. A number of submitters (e.g., PowerCo and Vector) were in agreement with this view.
- 22 The Act provides for the potential use of international data when setting the rates of change. The Commission considers that the inclusion of international data would be problematic given the need to source appropriate, comparable information and the likely need for normalisation. This would compound any data complexity issues that need to be resolved in the limited timeframe available to undertake the reset. The incorporation of international data in productivity analysis and using it to inform the setting of rates of change was not generally supported by submitters.
- 23 Under section 53P(7), the Commission may take into account the effects of inflation on the inputs of EDBs when setting the rates of change. In the December Discussion Paper the reference to inflation was interpreted as allowing for the use of alternative price indices. Accounting for input price differentials within the DPP through the use of alternative price indices was generally supported by submitters. The Commission has previously considered using alternative indices (e.g., Producer Price Index (PPI), Labour Cost Index (LCI) and Capital Goods Price Index (CGPI)) under the thresholds regime to take into account industry specific inflation. The Commission notes,

however, that such alternatives to CPI may not be sufficiently robust or stable and that the use of an excessively volatile index may lead to technical breaches<sup>3</sup>.

### *Initial Views on Rates of Change*

24 In light of relevant provisions, the objectives of the DPP reset and having considered the views of submitters, the Commission's initial views are that:

- a CPI-X based approach should form the basis of the price-path within the DPP;
- for the purpose of setting the rates of change for the DPP, TFP analysis is the Commission's preferred measure of productivity to inform the Commission's decisions on the level of the X-factor;
- the availability of information disclosure data for 2008/09 may place constraints on the productivity analysis that may be used to inform the rates of change, including the timing of an initial X-factor estimate (ideally included in the Discussion Paper) and an update of analysis including 2008/09 data (due to be disclosed in August);
- the option to use international data for suppliers in other comparable countries for the purposes of productivity analysis will not be employed; and
- the Commission will consider the use of alternative prices indices, but notes that a number of the alternatives to CPI may not be sufficiently robust or stable to include within the DPP.

### **Starting Prices**

25 Under the DPP, the Commission is required to specify starting prices for EDBs. Section 53P(3) stipulates that these should be specified as either of the following:

- (a) *the prices that applied at the end of the preceding regulatory period; or*
- (b) *prices, determined by the Commission, that are based on the current and projected profitability of each supplier.*

26 Option (a) is equivalent to the approach taken under the thresholds regime. Specification of starting prices for individual EDBs by the Commission (option (b)) is likely to be more appropriate under a DPP given the generic nature of the X-factor. Adjustments of starting prices would allow the DPP to better address the specific circumstances of individual EDBs. Starting price adjustments or  $P_0$  adjustments generally include the following inputs: regulated WACC; regulatory asset base; operational expenditure; depreciation; tax liability; interest tax shield; and revenue.

27 A number of these inputs will be calculated based on relevant input methodology determinations (e.g., cost allocation, asset valuation, cost of capital and tax). As noted above, the Commission must specify starting prices for EDBs in the DPP Determination by 1 December 2009. However, the input methodologies determination applicable to

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<sup>3</sup> The term "technical breaches", refers to breaches that are deemed to be beyond the direct control of a supplier.

EDBs will not be made until 30 June 2010. Section 54K(3) provides that, if an input methodology published after 1 April 2010 had applied at the time the DPP were reset, and the application of that methodology would have resulted in a materially different DPP being set, then the Commission may reset the DPP. The Commission then has nine months to undertake such a reset from the date of publication of the relevant input methodologies determination. In such circumstances, the Commission may apply “claw-back” (i.e., consumers or suppliers can be compensated for the previous over- or under-recovery of revenue associated with the change to the DPP).

- 28 Submissions to the December Discussion Paper expressed concerns about potential starting price adjustments taking place prior to the finalisation of input methodologies, including PwC who contend that “it is not possible to set starting prices before input methodologies have been determined as assessments of current and future profits rely on these”. The Commission considers it would be possible to reset starting prices based on the information available at that time. However, if the DPP reset were to include starting price adjustments, then it may be necessary to reopen the DPP and readjust starting prices following input methodology determinations. The readjustment would be used to rectify any material difference in outcomes between the initial adjustments and one applying the relevant input methodologies (e.g., cost allocation, asset valuation, cost of capital and tax). Such a readjustment would also be necessary to ensure consistency between the DPP framework and relevant input methodologies.
- 29 The Commission considers that there are two alternative approaches for starting prices when resetting the initial DPP.
- *Adjust starting prices for EDBs by 1 December 2009, taking into account current (and future) profitability.* If the input methodology determinations then lead to a material difference, then a further change to the price path may have to be made. Consequently, this approach may result in two  $P_0$  adjustments for EDBs within 18 months.
  - *Specify starting prices as those that applied at the end of the initial DPP.* Following publication of the input methodology determinations, starting prices would be adjusted, with ‘claw-back’ being applied, if required. This approach would only involve a single  $P_0$  adjustment and minimise uncertainty.

#### *Initial Views on Starting Prices*

- 30 The Commission considers that the application of relevant input methodologies could imply materially different starting prices. Notwithstanding the potential need for a second  $P_0$ , adjusting starting prices prior to the finalisation of input methodology determinations will lead to uncertainty and potential inconsistencies between the DPP framework and input methodologies.
- 31 Having considered the issues involved and relevant submissions, the Commission is of the view that starting prices should initially be specified as those applying at the end of the preceding regulatory period. Following the publication of input methodologies, the Commission would then assess EDB returns, make appropriate  $P_0$  adjustments and apply claw-back, where required. This will allow consistency with input methodologies to be achieved and allow adequate time to develop a methodology that took future, as well as current, profitability into account.

## Quality Standards

- 32 The Commission is required to set quality standards under the DPP. Section 53M(3) provides that “quality standards may be prescribed in any way the Commission considers appropriate”. The Commission has previously discussed dimensions of quality as part of the thresholds regime.<sup>4</sup> Of these, voltage stability and similar technical requirements are, to a large extent, beyond the direct control of EDBs (being driven largely by generator performance). The Commission has in the past considered reliability of supply to be the characteristic of most relevance to EDB quality performance and that SAIDI and SAIFI should be used to set and monitor reliability performance. The Commission considers that these views remain appropriate. Submissions to the December Discussion Paper generally supported the focus on reliability and the use of SAIDI and SAIFI.
- 33 Default/customised price quality regulation differs from the thresholds regime in a number of respects, including that breaches may result in civil or criminal penalties. Submissions suggested that this has implications as to how quality standards under the DPP should be defined and assessed. EDB reliability performance may be influenced by external factors and is subject to normal variation. Under the thresholds regime these factors contributed to a significant number of breaches. Investigation of these breaches did not raise concerns regarding the underlying reliability performance of the EDBs. Submissions have suggested that the more severe implications of a breach under a DPP require that breaches be minimised to cases that indicate deterioration in underlying reliability. The Commission considers that this view is reasonable and that quality standards under the DPP should be specified and assessed in such a way that minimises technical breaches, but indicates any deterioration in underlying quality. This may be achieved through the use of statistical measures such as moving averages and/or ‘dead bands’.
- 34 The Act provides for the use of an incentive mechanism for quality performance, e.g., an S-factor mechanism. Submissions to the December Discussion Paper supported the introduction of such a mechanism. However, the Commission considers that the development of an S-factor may not be feasible in the time frame available to the DPP project. Also, a lack of information on the value that consumers place on reliability and their willingness to accept price/quality trade-offs would make the specification of incentive levels somewhat arbitrary.

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<sup>4</sup> Parsons Brinckerhoff Associates, *Resetting The 2009 Quality Thresholds: Investigation Report*, 19 December 2007, p.11

*Initial Views on Quality Standards*

35 The Commission's initial views are that:

- reliability of supply will be the focus of quality standards under the DPP;
- SAIDI and SAIFI continue to be used to specify and monitor reliability of supply;
- the concerns of EDBs in respect of potential technical breaches under the DPP are valid and the Commission will seek to develop appropriate quality standards; and
- the development of an effective S-factor mechanism, while being a positive initiative, is not likely to be feasible during the timescale available to reset the initial DPP. A lack of information on consumer preferences supports the view that the development of such a mechanism may be better considered as part of a subsequent reset.

**Energy Efficiency**

36 Under section 54Q, the Commission must:

*Promote incentives, and must avoid imposing disincentives, for suppliers of electricity lines services to invest in energy efficiency and demand side management, and to reduce energy losses, when applying this Part in relation to electricity lines services.*

37 The provision requires that when applying Part 4 to EDBs, the Commission must promote incentives and avoid disincentives for:

- investments in energy efficiency and demand-side management; and
- reductions in energy losses.

38 Section 53M(3)(b) allows the Commission to consider reductions in energy losses when specifying quality standards under default/customised price-quality paths. This may be considered when developing quality standards, though inclusion of losses is unlikely to be straightforward, particularly given the inconsistent information available on EDB loss levels.

39 The December Discussion Paper indicated that the Commission recognised the importance of these energy efficiency matters and that it would seek to meet these objectives through the relevant regulatory instruments (DPP, information disclosure and CPP). The December Discussion Paper sought views from stakeholders as to how the Commission might promote incentives and avoid disincentives. Submissions in general supported the introduction of measures to promote incentives for EDBs to invest in energy efficiency.

*Initial Views on Energy Efficiency*

40 The Commission considers that all the mechanisms relating to Part 4 need not individually achieve the aims of section 54Q, but that the Part 4 regime as a whole, when applied to EDBs, should.

- 41 The Commission proposes seeking further views from EDBs on potential incentives and disincentives to investment in energy efficiency, particularly in relation to demand side management. The DPP, as envisioned, will be a relatively simple mechanism and may not readily be able to assess investments and their effectiveness in relation to increasing energy efficiency. However, under a more detailed CPP, the potential to allow for certain investments (e.g., low-loss transformers) to be included in the regulatory asset base may be a more appropriate instrument.
- 42 Considering the promotion of energy loss reduction separately, the Commission considers that there is a lack of sufficient and accurate information on both the level of losses and the respective responsibilities of EDBs and retailers. The Commission proposes that information disclosure, as one of the instruments under Part 4 that applies to electricity line services, be used to monitor and analyse energy loss levels, providing a degree of incentive for these to be managed. Over time this information could be used to inform mechanisms designed to provide stronger incentives.

### **Next Steps**

- 43 The Commission will finalise its process and set out further detail on the issues discussed following consideration of submissions. These views will be included in the Discussion Paper proposed for publication in May 2009.

## Submissions

- 44 Submissions are invited on this Process Paper, which sets out the Commission's proposed process for resetting the initial DPP and some initial views on matters relevant to the reset. Submissions should be received by the Commission no later than 5pm Monday, 13 April 2009 ("due-date"). All submissions should be supported by documentation and evidence, where appropriate.
- 45 In order to meet the time-frame prescribed in the Act, the Commission relies on submissions being provided by the due-date. The Commission will only allow extensions beyond the due-date if the submitter provides good reasons in writing. Unless an extension has been granted, the Commission may not be in a position to adequately consider submissions if received after the due-date.
- 46 To foster an informed and transparent process, the Commission intends to publish all submissions on its website. Accordingly, the Commission requests an electronic copy of each submission and requests that hard copies of submissions not be provided (unless an electronic copy is not available). Submissions should be sent to:

[NPB@comcom.govt.nz](mailto:NPB@comcom.govt.nz)

or

David Healy  
Chief Adviser  
Network Performance Branch  
Commerce Commission  
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### *Confidentiality*

- 47 Parties making submissions may wish to provide confidential or commercially sensitive information to the Commission. Parties can request that the Commission makes orders under s100 of the Act in respect of information that should not be made public. Any request for a s100 order must be made when the relevant information is supplied to the Commission and must identify the reasons why the relevant information should not be made public. The Commission will provide further information on s100 orders if requested by parties, including the principles that are applied when considering requests for such orders. Any s100 order will apply for a limited time only as specified in the order. Once an order expires, the Commission will follow its usual process in response to any request for information under the Official Information Act 1982.
- 48 The Commission discourages requests for non-disclosure of submissions, in whole or in part, as it is desirable to test all information in a fully public way. It is unlikely to agree to any requests that submissions in their entirety remain confidential. However, the Commission recognises there will be cases where interested parties making submissions may wish to provide confidential information to the Commission.

- 49 If it is necessary to include such material in a submission the information should be clearly marked and preferably included in an appendix to the submission. Interested parties should provide the Commission with both confidential and public versions of their submissions in both electronic and hard-copy formats. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.