



Submission on the discussion paper 'Reset of Default Price-Quality Path  
for Electricity Distribution Businesses'

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## 1 EXECUTIVE SUMMARY

- ❖ Eastland Network are party to the PricewaterhouseCoopers submission on behalf of 18 other EDBs and the submission provided by the Electricity Network Association. We fully support the comments made in these submissions. Given the importance of this subject, we are making our own submission on issues we believe are significant.
- ❖ Eastland Network agrees with the economic principles being essential within the regulatory framework, we believe that the purpose statement of the Commerce Act 1986 (the "Act") should be included on that level. The purpose statement is the core element of the regulatory framework for distribution businesses, as it defines the rationale for regulation, and needs to be recognized as such. Economic principles are set out for a market environment with perfect competition, hence limiting their applicability for regulated markets.
- ❖ The commencement date for the DPP reset is set to be 1 April 2010. Due to requirements of the Act (sec53P), the Commission is required to publish their default price-quality paths determination at least 4 month prior, i.e. 1 December 2009. We recommend that this time-frame is kept as it aligns with the annual publishing requirements for prices and pricing methodologies.
- ❖ We urge the Commission to use these powers given under sec53N, sec53ZD and sec98 with great care to avoid unnecessary compliance costs for the affected parties. We believe that annual Information Disclosure Requirements involving the disclosure of schedules providing financial, asset management, quality and performance data, pricing methodologies, asset management plans and threshold compliance statements give extensive insights into business operations.
- ❖ We support to not implement an inappropriately developed mechanism, we recommend instead that the Commission focuses on not creating any disincentives for investments in energy efficiency, for example by allowing for EDBs to make CPP proposals which provide for greater recognition of investment in energy efficiency and demand side management. We note however, since there is a high level of uncertainty around the acceptance of customised proposals, that this solution can only be temporary and that the Commission should develop an appropriate mechanism within the next regulatory period. Further to that, it is not satisfactory to rely on CPPs to provide energy efficiency mechanisms. Assuming that the majority of EDBs will be subject to DPP, the regulatory framework must primarily create incentives/ reduce disincentives for energy efficiency within the DPP. Information disclosure is not, as suggested by the Commission, the appropriate agent to create energy efficiency incentives.

- ❖ Transmission charges, local authority rates, Commerce Commission levies, and Electricity Commission levies are largely outside EDBs control and we support the Commission's view that it would not be cost effective to allow for anything other than 100% pass-through for the purpose of assessing compliance under a DPP.
- ❖ The Commission must specify a set of starting prices to apply to EDBs as at 1 April 2010. The Commission considers that there are two broad options regarding the definitions of starting prices:
  - those being charged by the EDB as at 31 March 2010 ("Actual Prices"); or
  - the maximum prices allowed under the respective EDB thresholds under the Initial DPP ("Allowed Prices").Eastland Networks supports the first option, that starting prices should be those being actually charged as at 31 March 2010.
- ❖ Eastland Network generally agrees to use a WACC/ ROI comparison to assess profitability. However, as the Commission notes in the discussion paper, the ROI by itself is not an absolute indicator of above- or below-normal returns and both measures bear a risk of statistical volatility. It is thus very important, that the WACC is set as accurately as possible to allow EDBs create a fair return on their investments.
- ❖ Eastland Network supports the Commission's preliminary view that an industry-wide cost of capital should be calculated for the New Zealand electricity distribution sector in accordance with the Commission's cost of capital input methodology, applicable for all EDBs.
- ❖ We agree that the provision of appropriate starting price adjustments is likely to contribute to limiting excessive profits, and provide for the sharing of efficiency gains with consumers. As discussed above, Eastland Network notes that it might be appropriate for some EDBs to adjust starting price adjustments upwards to facilitate sustainable investments.
- ❖ Eastland Network's view is that the Commission should use  $P_0$  adjustments to starting prices, applying for the period beginning 1 April 2011. However, where the Commission identifies necessary, we also agree that there may be certain cases where it is appropriate to adapt the level of individual adjustments with a view to avoiding significant price changes (upward or downward), through the use of a glide-path.
- ❖ As previously submitted<sup>1</sup>, Eastland Network believes that claw-backs should not apply. However if the Commission chooses to apply claw-back following the reset

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<sup>1</sup> Eastland Network Ltd (16 February 2009): *Submission on Regulatory Provisions of the Commerce Act 1986*

DPP starting prices, we agree with the Commission that claw-back should be well specified if it is to be used and only applied in exceptional circumstances, which would also need to be clearly set out in advance. This will increase the level of certainty around this matter.

- ❖ Eastland Network is concerned that data, based on historic productivity measures collected during a period of general economic growth, may not appropriately reflect the economic climate during the period of the reset DPP. Thus, Eastland Network greatly approves of the Commission's approach that will take other relevant considerations into account when setting the X-factor and should not just mechanically apply the results from any analytical technique such as TFP. Statistical methodologies should only be used to provide input to the Commission's thinking, and results given appropriate weight in light of other relevant considerations. Further to that, we believe that a forecast CPI compared to a lagged CPI may be better suited to meet the changing economic climate.
- ❖ On matters regarding TFP analysis and the setting of quality standards we look forward to further consultation and recommend the Commission gives the additional material provided by the ENA full consideration.

## 2 INTRODUCTION

### *2.1 Introduction to Eastland Network Ltd*

Eastland Network Limited owns and operates the lines for the upper East Coast of the North Island. Eastland Network is 100% owned by the Eastland Community Trust with the Gisborne District Council as the capital beneficiary of the Trust.

Eastland Network distributes approximately 302 GWh of electricity to approximately 26,000 consumers, of which almost two thirds are in Gisborne City and Wairoa Township. The remaining connections are spread out widely, across two isolated distribution networks covering 11,952km<sup>2</sup>, resulting in an overall line density of less than seven connections per kilometre of line.

### *2.2 Structure of this Submission*

Since the beginning of the Commerce Act review, Eastland Network has followed the development with great interest and has actively participated in the consultation processes in the belief that joint efforts achieve the best possible outcome. Eastland Network appreciates the opportunities afforded by the consultation processes. We thank the Commerce Commission (the "Commission") for continuing engagement with the industry and for providing us with an opportunity to respond to the discussion paper.

Our views are aligned with the views taken by the Electricity Network Association (ENA) and PricewaterhouseCoopers (PWC), which reflect the collective view of the industry, and ENL proposes the Commission gives these views considerable weight.

This submission provides Eastland Network's opinion on the matters raised by the Commission in their process and issues paper regarding the Commission's proposed approach on how to reset the default price-quality paths for non-exempt electricity distribution businesses (EDBs). We comment on:

- Form of the default price-quality path
- Starting prices and further reset prices
- Rates of change
- Time-frame for the reset
- Quality standards
- Energy efficiency
- Timeframe for reset

Eastland Network does not wish to be heard in support of this submission.

### 3 BACKGROUND

Under subpart 9 of Part 4 of the Commerce Act 1986 (the "Act"), suppliers of electricity lines services are subject to price-quality regulation. The provisions of subpart 9 of Part 4 commenced on 1 April 2009. Electricity distribution businesses (EDBs) that do not meet the criteria of being "consumer-owned" are subject to default/customised price-quality regulation. The main features of default/customised price-quality regulation, which replaces the Part 4A thresholds regime, are:

- the Commission determines default price-quality paths ("DPPs") that apply for a regulatory period;
- individual suppliers may make proposals to the Commission for a customised price-quality path ("CPP") and propose alternative price and/or quality paths;
- the Commission may set a CPP for the supplier that better meets that supplier's particular circumstances; and
- any breaches of price-quality paths are subject to the penalty provisions as set out in Part 6 of the Act.

For the period from 1 April 2009 to 31 March 2010, transitional arrangements have been made. The thresholds that were in place at 31 March 2009 remain the same for non consumer-owned EDBs for another year until 31 March 2010, i.e. the same X-factors and quality thresholds continue to apply.

The Commission is required to reset the initial DPPs by 1 April 2010. The relevant process for resetting starting prices, rates of change, and quality standards is set out in sec53P of the Act. The Commission is required to determine the new DPPs at least 4 months before the DPPs take effect, i.e. by 1 December 2009.

Subsequent to previous consultation rounds in December 2008 and March 2009, the Commission issued a consultation paper titled "Reset of Default Price-Quality Path for Electricity Distribution Businesses" and additional supporting papers on 19 June 2009. The consultation paper sets out the Commission's preliminary views on the proposed content and form of the DPP to take effect from 1 April 2010 ("Reset DPP").

## 4 COMMENTS

In this section Eastland Network provides comments on the issues raised in the consultation paper. The focus is on matters directly related to our business operations.

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

Any reward mechanism under a DPP needs to provide for EDBs to make an adequate and reasonable return on their investments. For example, businesses could be allowed to retain the efficiency gains achieved through innovative behaviour for a set period before passing on efficiency gains to consumers, effectively creating an incentive to innovate.

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

On p. 10 in the consultation paper, the Commission provides an overview of the regulatory framework. The basis is formed by the economic principles allocative, dynamic and productive efficiency and the implementation principles consistency, flexibility, transparency and cost-effectiveness. Even though, Eastland Network agrees with these principles being essential within the regulatory framework, we believe that the purpose statement of the Commerce Act 1986 (the "Act") should be included on that level. The purpose statement is the core element of the regulatory framework for distribution businesses, as it defines the rationale for regulation, and needs to be recognized as such. Economic principles are set out for a market environment with perfect competition, hence limiting their applicability for regulated markets.

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

N.A.

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

Eastland Network agrees that the timeframes suggested by the Commission regarding the commencement date (1 April 2010), the regulatory period (5-years), the annual CPP proposal submission date and the annual compliance date (within 35 working days of the conclusion of the regulatory year) are reasonable.

*Q.5) Are there any other relevant timeframes that should be included in a Determination, but have not been discussed in this paper?*

The commencement date for the DPP reset is set to be 1 April 2010. Due to requirements of the Act (sec53P), the Commission is required to publish their default

price-quality paths determination at least 4 month prior, i.e. 1 December 2009. We strongly recommend that this time-frame is kept as it aligns with the annual publishing requirements for prices and pricing methodologies. Missing this deadline may cause EDBs to subsequently miss their deadlines for notification of prices under their Use of System agreements with retailers.

*Q.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?*

The Commission proposes to include in a determination additional contents around

- the interpretation of involved terms,
- background information,
- demonstration of compliance,
- verification of compliance,
- change in circumstances,
- provisions for exemptions, and
- miscellaneous provisions.

Regarding the demonstration of compliance, the Commission is given a certain level of discretion under sec53N, sec53ZD and sec98. We urge the Commission to use these powers with great care to avoid unnecessary compliance costs for the affected parties. We believe that annual Information Disclosure Requirements involving the disclosure of schedules providing financial, asset management, quality and performance data, pricing methodologies, asset management plans and threshold compliance statements give extensive insights into business operations.

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

We agree with the Commission in acknowledging the complexities of this issue and the risks of implementing an energy-efficiency mechanism that is not sufficiently robust and fully developed. While we support to not implement an inappropriately developed mechanism, we recommend instead that the Commission focuses on not creating any disincentives for investments in energy efficiency, for example by allowing for EDBs to make CPP proposals which provide for greater recognition of investment in energy efficiency and demand side management. We note however, since there is a high level of uncertainty around the acceptance of customised proposals, that this solution can only be temporary and that the Commission should develop an appropriate mechanism within the next regulatory period. Further to that, it is not satisfactory to rely on CPPs to provide energy efficiency mechanisms. Assuming that the majority of EDBs will be

subject to DPP, the regulatory framework must primarily create incentives/ reduce disincentives for energy efficiency within the DPP. Information disclosure is not, as suggested by the Commission, the appropriate agent to create energy efficiency incentives.

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

The Electricity Commission (EC) has recently resurrected its work on model approaches to EDB pricing. Under the Information Disclosure requirements, EDB disclosure of Pricing Methodology is mandatory, however it is considerably less prescriptive than the model approach adopted by the EC. We encourage the Commission and the EC to work closely together on these tranches of work to prevent any divergence of requirements or risk an increasing of the compliance workload placed on EDBs.

*Q.9) What are your views on the appropriate methods for analysing current and projected profitability?*

We believe that the Commission should use the publicly available information as a basis for assessing current and future profitability. The data sources include Information Disclosure statements and Asset Management Plans.

Further more, we believe that ROI is the best measure of profitability but only when assessed against a reasonable and accepted industry-wide Weighted Average Cost of Capital (WACC). However, given the potential variability in future Asset Management Plans as well as costs incurred, a scenario and sensitivity based assessment of future profitability is required. This would return a range of ROIs, indicating the potential profitability of the EDBs in the future.

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

A stated under Q6 Eastland Network believes that current Information Disclosure Requirements provide a comprehensive insight into the electricity distribution sector and individual businesses. Particularly the asset management plans give ample information on future expenditure and the condition of the network. Given the high level of data that is already publicly available, we believe that this is sufficient and recommend the Commission avoids requesting further information from EDBs.

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

Please refer to Eastland Network's comments to Q54.

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

Eastland Network supports the views taken by the ENA and by the ENA-Regulatory Working Group on that matter.

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

Under the old thresholds regime, all EDBs were subject to a price-quality path. This regulatory arrangement was based on the Commission's view, that price and quality were the two key elements to meet the long-term interests of consumers and the efficient operation of EDBs. Because price-cap regulation provides cost-reducing incentives that might affect the quality of service, the Commission incorporated special provisions to prevent a decline of quality.

Under the new Part 4 regime, all non-exempt businesses are subject to price-quality regulation and have to demonstrate annually their compliance. A critical difference to the old regime is that a breach of the DPP could now invoke the penalty provisions under Part 6 of the Act.

Eastland Network agrees with the Commission that the concept of a dual-path is appropriate for a DPP. Though, we urge the Commission to be mindful when setting the DPP that breaches of the DPP are subject to pecuniary penalties under Part 6 of the Act.

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

We agree with the Commission that circumstances leading to reconsideration of the DPP within a regulatory period should form part of the input methodologies. We also support the Commission's view that "re-openers" should provide for unforeseen and uncontrollable events that are beyond a supplier's control and be of material nature to the EDB, so that the existing price-quality path becomes inappropriate for the change in

circumstances and requires resetting. Given the Commission's acknowledgement that an individual EDB, suffering from a business-specific event, can apply for a customised path and that the Commission will take that into account when prioritizing customised proposals, we agree that re-openers should be limited to events that affect the whole industry.

Assuming provisions for re-openers will become input methodologies, it is appropriate for them to be published once input methodologies are finalized and are not of immediate importance for the interim period 1 April 2010 to 31 March 2011.

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

Eastland Network believes that pricing methodology can only be a principle based approach, in a way that it provides voluntary guidance for EDBs. At present, the majority of EDBs use either the "Retail Delivery Model" or the "Wholesale Delivery Model". We are of the opinion that both models meet the regulatory purpose and the choice of model should ultimately be left to the individual EDB, as EDBs can best assess which model meets their specific needs. We regard a "one-fits-all" approach as inappropriate for distribution services and strongly recommend that a pricing methodology is developed for guidance purposes only.

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

Eastland Network supports the use of this type of approach to assess compliance with the price-path.

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

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

The Commission proposes to include the following as pass-through costs:

- transmission charges,
- local authority rates,
- Commerce Commission levies, and
- Electricity Commission levies.

These charges are largely outside EDBs control and we support the Commission's view that it would not be cost effective to allow for anything other than 100% pass-through for the purpose of assessing compliance under a DPP.

*Q.19) Are the Commission's proposed definition of price and the associated definition of excluded services appropriate? If not, please explain.*

For potentially "excluded" services under Part 4, the Commission's proposes that the definition of excluded services might include:

- a. any electricity lines services if there is workable or effective competition for the provision of those services; or
- b. electricity lines services for which loss and constraint rentals are paid, if the amounts received for those services are passed on transparently and in full to its customers.

Eastland Network regards the proposed definition for excluded services as appropriate.

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

No comment.

*Q.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?*

In our submission on the Provisions Paper, we suggested that starting prices should be adjusted upward where necessary to ensure sufficient cash flow for investment where starting prices have been set too low<sup>2</sup>.

The Commission suggests that some business-specific circumstances, such as those relating to cash flows, might be more effectively and appropriately considered as part of evaluating a CPP proposal. We note that there is still a high level of uncertainty around customised solutions and recommend, the Commissions tries to address as many issues as possible within the structure of the reset.

*Q.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.*

We agree with the Commission to defer starting price adjustments until after input methodologies are finalized.

*Q.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)?*

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<sup>2</sup>[http://www.comcom.govt.nz//IndustryRegulation/Electricity/PriceQualityPaths/ContentFiles/Documents/Eastland%20Network%20-%20823337\\_1.pdf](http://www.comcom.govt.nz//IndustryRegulation/Electricity/PriceQualityPaths/ContentFiles/Documents/Eastland%20Network%20-%20823337_1.pdf)

The Commission provides the following indicative time table for starting price adjustments.

| <b>Date</b>           | <b>Milestone</b>   |
|-----------------------|--|
| 1 December 2009       | Publication of DPP Determination specifying prices as at 31 March 2009 as starting prices                |
| 1 April 2010          | Reset DPP comes into effect  |
| 30 June 2010          | Input Methodologies Published  |
| August/September 2010 | Consultation Process on starting price adjustments   |
| November 2010         | Amended DPP published, including starting price adjustments and application of claw-back, as appropriate |
| 1 April 2011          | Starting price adjustments take effect   |

We regard the proposed process as appropriate.

*Q.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)?*

The Commission must specify a set of starting prices to apply to EDBs as at 1 April 2010. Under section 53P(3), the Commission is required to specify these as either

- the prices that applied at the end of the preceding regulatory period, or
- as prices that are based on the current and projected profitability of each supplier.

The summary of the Reset DPP determination—to be published by 1 December—will specify whether current prices or prices adjusted by the Commission will apply.

The Commission delineates that starting price adjustments should follow the publication of input methodologies.

Therefore, the Commission would be required to specify in the DPP determination the starting prices applying from 1 April 2010 as those prices that applied at the end of the preceding regulatory period, which in this context is the assessment year between 1 April 2009 and 31 March 2010.

This implies that the prices that apply at the end of the Initial DPP would be the starting prices specified for the Reset DPP. The Commission considers that there are two broad options regarding the definitions of starting prices:

- those being charged by the EDB as at 31 March 2010 (“Actual Prices”); or
- the maximum prices allowed under the respective EDB thresholds under the Initial DPP (“Allowed Prices”).

Eastland Networks supports the first option, that starting prices should be those being actually charged as at 31 March 2010.

Currently, conformance with the Price Path Threshold is assessed using pricing that are inclusive of pass through costs, i.e. Transpower rates and other levies. We believe that the starting prices for the next regulatory period should be exclusive of all Transpower costs. As previously discussed, pass through costs are generally outside of an EDB's control and therefore, including them in the calculation of an EDB's performance against the Price Path Threshold can lead to erroneous results.

*Q.25) What are your views on the WACC measure appropriate for comparing with a ROI in assessments of current profitability?*

Adjustments of starting prices will include an assessment of EDB profitability, as starting prices are to be determined by the Commission based on the current and projected profitability of each supplier.

Currently, an EDB's return on investment (ROI) is compared against an estimated industry-wide WACC. As with many statistical measures there are some detriments to the concepts. Based on historical accounting information, the ROI is a historical or current measure of returns and provides an approximation to the economic returns earned over the lifetime of the relevant assets.

WACC traditionally represents the minimum rate of return necessary to attract debt and equity capital to an investment, and is of forward-looking nature. A WACC determined by input methodologies is likely to apply on an industry-wide basis.

Eastland Network generally agrees to use a WACC/ ROI comparison to assess profitability. However, as the Commission notes in the discussion paper, the ROI by itself is not an absolute indicator of above- or below-normal returns and both measures bear a risk of statistical volatility.

It is thus very important, that the WACC is set as accurately as possible to allow EDBs create a fair return on their investments.

*Q.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.*

*Q.27) How do you consider a time series of cost data could inform the assessment of current profitability?*

*Q.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?*

We support the ENA and PWC submissions on this matter.

*Q.29) What are your views on the Commission estimating an industry-wide WACC using historical data to inform current profitability assessments?*

*Q.30) What are your views on whether an industry-wide WACC should be used to inform projected profitability?*

Eastland Network supports the Commission's preliminary view that an industry-wide cost of capital should be calculated for the New Zealand electricity distribution sector in accordance with the Commission's cost of capital input methodology, applicable for all EDBs.

Eastland Network recommends, as suggested in the discussion paper, that the Commission undertakes an assessment of current profitability using partial building blocks analysis to estimate an EDB's ROI, which is then assessed against a point estimate of an industry-wide WACC as a reference for determining whether a starting price adjustment is appropriate.

We agree that the provision of appropriate starting price adjustments is likely to contribute to limiting excessive profits, and provide for the sharing of efficiency gains with consumers. As discussed above, Eastland Network notes that it might be appropriate for some EDBs to adjust starting price adjustments upwards to facilitate sustainable investments.

*Q.31) What are your views regarding a quantitative returns-based assessment of projected profitability under the DPP?*

The Commission explains in the discussion paper that in order to undertake a returns-based assessment of future profitability, the Commission would be required to either:

- (a) estimate an EDB's future profits; or
- (b) assess profit forecasts provided by the EDB.

Both options would require the Commission to consider the forecasted values of an EDB's ROI and WACC. Because the forecasting typically involves the use of a full building blocks analysis, we agree with the Commission's preliminary view that the scope of the DPP should not extend to the use of full building blocks analysis or similar forecast assessments and an alternative means of accounting for projected profitability should be used.

*Q.32) What are your views on the Commission's proposed approach for assessing projected profitability to inform its adjustments of starting prices?*

*Q.33) What other options do you consider there are for assessing projected profitability?*

*Q.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?*

*Q.35) What time period should assessments of projected profitability cover e.g. should these assessments consider periods beyond the applicable regulatory period?*

The assessment of projected profitability should be limited to the current regulatory period. Outside of this period, there are too many unknown variables in network growth, Asset Management, technology developments and regulation/ legislation.

*Q.36) What are your views on the proposed two-step approach to calculating starting price adjustments?*

*Q.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?*

*Q.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?*

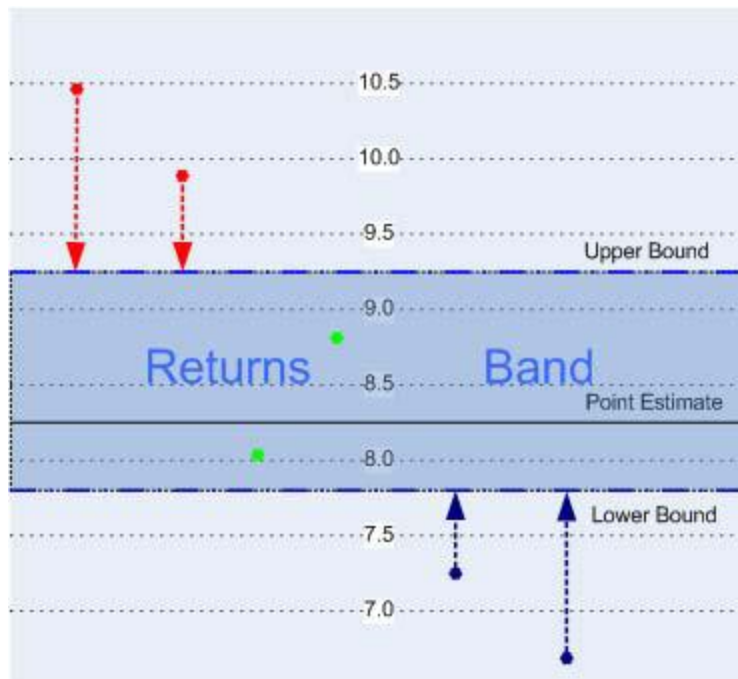
*Q.39) How should EDBs that are likely to face scenarios affecting projected profitability be treated? Should adjustments be made to their returns-band? If so, how should this be done?*

The Commission proposes that the adjustment of starting prices could effectively have two stages:

1. Adjustment primarily based on a comparison of an EDB's ROI with an industry-wide WACC estimate subject to a returns-based adjustment,
2. Possible further adjustment for those EDBs whose projected profitability may be affected by certain scenarios.

The Commission notes that ROI based on current year's data alone might inadequately reflect longer term profitability as a result of potential volatility in annual opex and other relevant factors. To reduce the risk of forecast imprecision as such, the Commission proposes that the adjustment could be based on a comparison of an EDB's current ROI versus a range of 'banded returns', as illustrated below (Figure 1). This will potentially

average out the fluctuations in the ROI, making it more appropriate when comparing with the WACC.



**Figure 1:** Example of an Asymmetric Banded Returns Approach

The table below shows the implications of the position of an EDB’s ROI relative to the boundaries regarding the starting price adjustment.

| Position relative to Band | Initial Adjustment | Targeted Return               |
|---------------------------|--------------------|-------------------------------|
| EDB is Above              | Mandated Reduction | Upper-boundary                |
| EDB is Within             | No Adjustment      | EDB to remain within the band |
| EDB is Below              | Allowed Increase   | Lower-boundary                |

If the ‘banded-returns’ approach is used, it will be very important that the appropriate level of the upper and lower bound is determined.

For the current reset, Eastland Network supports the Commission’s preliminary view that it may be appropriate to use a two-step approach when informing the adjustment of starting prices and welcome further consideration on this matter following the publication of input methodologies.

*Q.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?*

The Commission notes that it could adjust starting prices in one of two forms: a one-off  $P_0$  adjustment or a "glide-path". The glide-path approach allows for the setting of alternative rates of change for a particular supplier, and these may include step-changes. We agree that such an approach might be appropriate for a particular EDB to minimise undue financial hardship to the supplier or minimise price shocks to consumers. The Commission notes that a 'banded-returns' approach may reduce the likelihood of adjustments that would lead to financial hardship or price shocks.

Eastland Network's view is that the Commission should use  $P_0$  adjustments to starting prices, applying for the period beginning 1 April 2010. However, where the Commission identifies necessary, we also agree that there may be certain cases where it is appropriate to adapt the level of individual adjustments with a view to avoiding significant price changes (upward or downward), through the use of a glide-path.

*Q.41) Under what circumstances do you consider it would be appropriate for the Commission to apply claw-back?*

*Q.42) How should claw-back be applied? Should it be done as an additional  $P_0$  adjustment or using a glide-path?*

As previously submitted<sup>3</sup>, Eastland Network believes that claw-backs should not apply or only in extreme circumstances. However if the Commission chooses to apply claw-back following the reset DPP starting prices, we agree with the Commission that claw-back should be well specified if it is to be used and only applied in exceptional circumstances, which would also need to be clearly set out in advance. This will increase the level of certainty around this matter. Currently, the mechanism is not fully understood nor the trigger points for it properly defined.

If claw-back did apply our preference is for the glide-path approach, as it will likely reduce shocks for the business.

*Q.43) To what extent will a recessionary economic climate impact differently on the productivity of EDBs and the economy as a whole?*

*Q.44) What are your views on the potential promotion of energy efficiency through the setting of the X-factor?*

The Commission is required to set a rate of change ("X-factor") for EDB prices during the regulatory period. The Act provides for the X-factor for EDBs under a DPP to be "based on the long-run average productivity improvement rate achieved" by EDBs using whatever measures of productivity analysis the Commission considers appropriate.

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<sup>3</sup> Eastland Network Ltd (16 February 2009): *Submission on Regulatory Provisions of the Commerce Act 1986*

Either a single rate of change is applicable for all EDBs, or the Commission can choose to apply alternative rates for certain circumstances.

Because historic-based productivity measures use data that was mainly collected during a period of general economic growth, Eastland Network is concerned that this data may not appropriately reflect the economic climate during the period of the reset DPP.

Thus, Eastland Network greatly approves of the Commission's approach that will take other relevant considerations into account when setting the X-factor and should not just mechanically apply the results from any analytical technique such as TFP. Statistical methodologies should only be used to provide input to the Commission's thinking, and results given appropriate weight in light of other relevant considerations.

*Q.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)?*

N.A.

*Q.46) What are your views on the amended TFP formula? What are your views on the proposed practical application?*

N.A.

*Q.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?*

*Q.48) What are your views on an appropriate method of forming an IHC time series? How should this be achieved?*

Eastland Network agrees with the Commission's preliminary view is that the 2004 ODVs would appear to be the best starting point given that they are the first valuations to contain accurate and appropriate treatment of underground cables and sufficiently detailed information to allow asset specific input shares to be used for productivity analysis. We also support the approach to continue the already existing indexed database from 2004 before choosing a new methodology such as IHC or HC.

*Q.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?*

*Q.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?*

*Q.51) What are your initial views on whether an approach that accounts for sunk costs might effectively implement the input price differential?*

*Q.52) How should the Commission estimate capital expenditure for the forthcoming regulatory period in a cost effective manner?*

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

The initial DPP formulae use a fixed base quantity in the formation of both notional revenue and maximum allowable notional revenue, which is generally the quantity applying in the year ending 31 March 2003. We agree that the composition of output changes over time so that fixed base quantities will become increasingly unrepresentative over time.

Continuous updating of base period quantities is likely to better reflect current circumstances and should be applied when resetting the price-path. This allows changes in output composition and consumer preferences to be better recognised while reducing potential distortions from pass-through cost anomalies.

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

The Commission indicates in the consultation paper that their preliminary view is that the price-path should be implemented involving a CPI-X mechanism. This requires the assessment of the annual notional revenue with regard to changes in CPI. Forecasting CPI development bears a risk of forecast errors, which can cause technical breaches and causes uncertainty for regulated businesses. To avoid this, the Commission proposes to amend the method in which the CPI is accounted for and use a 6-month lagged CPI.

Eastland Network agrees with the Commission that a forecast CPI has the identified risks and that a lagged CPI potentially addresses these problems. However, the risk of inaccuracy remains due to the timing difference.

Particularly for the upcoming reset, we are concerned that current economic developments will result in a distorted CPI. A particularly low CPI may lower the price-path substantially more than appropriate to meet future economic developments. Based on that, we believe that a forecast CPI may be better suited to meet the changing economic climate.

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

We support the use of a recognised forecast for CPI and would suggest that the Commission supplies EDBs with a forecast CPI for pricing purposes each year. This could be from an independent reputable source or the reflection of differences between indexed and non-indexed bond rates.

The Commission indicates their intention to undertake further research on a suitable CPI methodology before implementation and we welcome further analysis on that matter.

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

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

Eastland Network considers the inclusion and treatment of local authority rates and Electricity Commission levies, being beyond the control of EDBs, is appropriate, and that the costs identified in the answer to Q17/18 should be included in the pass-through term.

The Commission defines the transmission charge as “*the net amount a distribution business is liable to pay to Transpower or other parties for transmission services (or avoided transmission services)*”. We support that charges and rebates associated with the transmission network are largely beyond the control of EDBs and therefore, should be considered for inclusion as a pass-through cost in price-control assessments. However, we have some concerns as the existing approach requires EDBs to estimate precisely the annual costs of transmission charges, bearing the associated revenue risk of any under or over recovery.

To avoid this risk, the Commission proposes to account for transmission charges when assessing compliance with the price-path. Eastland Network agrees that accounting explicitly for transmission charges in a robust and predictable manner might increase certainty and transparency within the DPP mechanism.

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

We believe that the removal of transmission pass-through cost would resolve the anomaly immediately.

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

Prices are already "unbundled" as EDBs are required to publish prices showing distribution and transmission components.

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

No comment.

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

In addition to price regulation, the Act provides for the regulation of EDBs' service quality. This is based on the argument that under price-cap regulation firms are constrained in their ability to raise prices. In order to reduce costs and effectively improve the return, necessary investments might not be carried out causing quality levels to drop. Regulation of service quality levels addresses this issue.

The Commission proposes to include quality standards under a separately assessed quality-path. We agree that this is an appropriate method for promoting incentives for EDBs to provide sustainable quality levels that reflect consumer demands.

We support a separately assessed quality path until such time as better mechanism are fully developed and understood by the industry such as an S-factor.

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

To the extent that the customer is willing to pay for it and that an EDB can receive a return on the investment as an incentive to make that investment.

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

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

Eastland Network looks forward to further consultation on this matter and recommends the Commission considers the additional submission by the ENA on this matter which will be forwarded to the Commission on or before 31 July 2009.

However, we agree with the Commission's preliminary view that breaches relating to quality should occur where there is a material deterioration in service levels. In order to

reduce the risk of technical breaches quality standards under the DPP should be set and assessed appropriately.

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

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

EDBs already provide comprehensive information on consumer engagement as part of Asset Management Plans. This information is publicly disclosed and we believe that this is the appropriate regulatory mechanism for this purpose.

*Q.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?*

We regard the use of a five-year historic average as the basis for quality standards under the DPP as appropriate. Historical average SAIDI and SAIFI values should take account of data sensitivity caused by extreme and normal variations. We support a normalised five-year historic average, assuming it is likely to better reflect an EDB's underlying reliability than a single year's performance data, and that assessments are likely to better indicate whether there has been no material deterioration in performance. A five-year average is likely to minimize statistical volatility even though it does not completely erase it, reducing the risk of technical breaches.

*Q.68) What are your views on the proposal to include 2008/09 non-normalised daily outage data?*

We support the Commission's view that there may be some benefits of using the most up-to-date information as this is likely to be more reflective of current underlying performance. Given the timing of the DPP Reset and a preference to use data collected on an assessment year basis, The Commission points out that if the most recent data were used, the relevant data should relate to the 1 April 2005 to 31 March 2009 period. This would require the Commission to obtain additional daily outage data from EDBs for the 2008/09 regulatory year.

The Commission has previously used its information gathering powers under sec98 to require this information and proposes to use its information gathering powers under the Act to request a similar set of data for the 2008/09 period, noting that this information would be used to inform the modeling and analysis of the proposed quality standard, although it would not be essential for setting the quality standard formula against which compliance would be demonstrated. Based on that and the given workload within the

tight timeframe for the reset, we recommend the Commission uses the data that is already available.

*Q.69) What are your views on the appropriateness of the IEEE 2.5 Beta Method for identifying extreme variability in quality data?*

*Q.70) What are your views regarding any other appropriate methods for identifying extreme variability that could be implemented under DPP reset?*

We support PWC's and ENA's submissions on the topic of identifying extreme variability.

*Q.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.*

*Q.72) What are your views as to appropriate methods for calculating the size of the dead-band?*

We support PWC's and ENA's submissions on this matter.

*Q.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?*

We support the use of moving average. However, we note that if planned maintenance activities are discussed within an AMP adversely affect quality scores, this could reduce or eliminate any incentives to invest.

*Q.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?*

*Q.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?*

Eastland Network believes multi-year assessment is appropriate, however we would question whether it is appropriate to use data from the previous regulatory period for determining quality scores.

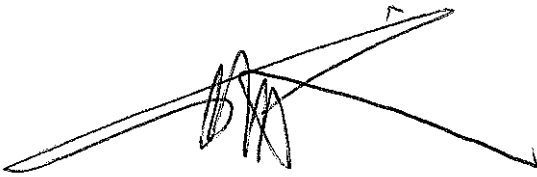
*Q.76) What are your views on the Commission's proposed approach for assessing quality standards under the Reset DPP?*

On this matter, Eastland Network supports the views taken by the ENA and PWC in their respective submissions.

17 July 2009

Submission on the Reset of Default Price-Quality Path for EDBs

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Matt Todd', is written over a long, thin horizontal line that spans across the signature.

Matt Todd

**Chief Executive – Eastland Group**

For further enquiries on this submission, please do not hesitate to contact Henrike Seifert (ph 06 8691 603, email: [henrike.seifert@eastland.co.nz](mailto:henrike.seifert@eastland.co.nz)) or Ben Gibson (ph 06 8690 725, email: [ben.gibson@eastland.co.nz](mailto:ben.gibson@eastland.co.nz)).