

**Submission to the Commerce Commission**

**on**

**Default/customised Price-quality Regulation**

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

**Process and Issues Paper**

**Made on Behalf of  
21 Electricity Distribution Businesses**

**15 April 2009**

## Submission on the Reset of the Default Price-quality Path for Electricity Distribution Businesses

A revised regulatory regime for electricity lines businesses (ELBs), gas pipeline businesses (GPBs) and major international airports came into effect on 14 October 2008, with some provisions for ELBs delayed until 1 April 2009, via a new Part 4 of the Commerce Act 1986 (the Act).

Accordingly, an initial default price-quality path (DPP) is to apply to Electricity Distribution Businesses (EDBs) which do not meet the consumer-owned exemption criteria (non-exempt EDBs) specified in the Act, for the period 1 April 2009 – 31 March 2010. This default price-quality path is to be reset at 1 April 2010. The Commerce Commission (the Commission) has released a Process and Issues Paper: *Reset of Default Price-quality Path for Electricity Distribution Businesses, Process and Issues Paper, 30 March 2009* (the Paper), which sets out its proposed process for resetting the initial DPP for EDBs by 1 April 2010. The Paper also provides the Commission's initial views on a number of issues relevant to the DPP reset.

This document forms our submission on the Paper which has been prepared by PricewaterhouseCoopers on behalf of the following 21 EDBs:

- Alpine Energy Limited
- Buller Electricity Limited
- Counties Power Limited
- Eastland Network Limited
- Electra Limited
- Electricity Ashburton Limited
- Electricity Invercargill Limited
- Horizon Energy Distribution Limited
- MainPower New Zealand Limited
- Marlborough Lines Limited
- Nelson Electricity Limited
- Network Tasman Limited
- Network Waitaki Limited
- Northpower Limited
- OtagoNet Joint Venture
- Scanpower Limited
- The Lines Company
- The Power Company Limited

- Top Energy Limited
- Waipa Networks Limited
- Westpower Limited.

This group of EDBs together comprises 494,798 connections (or 26% of the total electricity distribution sector), and 64,131 system kilometres (43% of the total electricity distribution sector).<sup>1</sup> The ownership structures represented include consumer and community trusts, a listed company, local body and co-operative ownership, as well as those managed by management companies. Group members include networks with predominantly urban systems, others that are sparsely populated and a number with significant urban areas combined with rural and remote rural characteristics.

## **Our Submission**

1. The Paper covers five key topics, as follows:
  - (a) The proposed timing and consultation process for the DPP reset
  - (b) The rates of change to be adopted for the price component of the DPP
  - (c) The starting prices to be adopted for the price component of the DPP
  - (d) The quality standards to be adopted for the quality component of the DPP
  - (e) The proposed approach to addressing the energy efficiency requirements stipulated in the Act.

We address each in turn in the remainder of our submission.

2. A number of the EDBs which support this submission have also independently made their own submissions directly to the Commission on points of specific interest to them.

## **Process and Timing for the DPP Reset**

3. We note the Paper's acknowledgement of the tight timeframes imposed by the statutory deadlines for the DPP reset and the recognition of this in the process and timing proposed for the reset. In particular we welcome the positive response by the Commission to requests for additional dialogue with stakeholders in addition to the formal consultation process. We note that the Electricity Networks Association's (ENA's) submission identifies areas where additional work is being undertaken on behalf of the electricity distribution sector to assist the Commission with the DPP reset. We also acknowledge the Commission's statement that any

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<sup>1</sup> Based on 2007 Information Disclosure Data

additional dialogue with EDBs will not replace the need for, or the role of, the formal consultation process.

4. The proposed timetable for resetting the DPP is as follows:
  - Discussion Stage - presenting preliminary views on the DPP and how it should be determined, culminating in a Discussion Paper due in May for consultation over a six week period
  - Decision Stage – involving a Draft Decisions Paper in September 2009, following consideration of submissions on the Discussion Paper, with consultation over a six week period. This will culminate in a Final Decisions Paper due mid November 2009 with a possible additional one week consultation on this
  - Drafting Stage - presenting a Draft Determination in November 2009 for consultation over a two week period, in parallel with the consultation on the Final Decision, culminating in a Final Determination late November 2009.
  
5. It is extremely useful to have advanced notice of this timetable at this stage as it allows the EDBs which support this submission to plan their resource availability for the consultation periods. In this respect, it would also be helpful if it were possible for the Commission to provide early indication as to whether the Discussion and Draft Decision Papers are likely to be released at the beginning, mid or late May and September respectively.
  
6. We also note that it is extremely important for EDBs to be able to understand the impact of the proposed DPP on their businesses as early in the process as possible. This means as much detail as early as possible for EDBs to be able to consider the proposals, analyse the impact on their businesses and prepare their responses to the consultation papers accordingly. We have been frustrated in the past by insufficient time to respond to the detail which has emerged relatively late in the consultation process. EDBs will be keen to model potential DPP outcomes, in order to be able to discuss them with their management teams, boards and owners. This needs to occur before the Decision Stage of the process, during the Discussion Stage.
  
7. We therefore urge the Commission to include as much detail as possible about its proposals in the May 2009 Discussion Paper, to enable EDBs to undertake the analysis required of them to be able to respond as fully and as constructively as possible in June. This will ensure the Commission has sufficient time to be able to fully consider their responses, and if necessary make changes and refinements to the proposed approach between the Discussion Stage and the Decision Stage.

8. The Paper notes that the Commission considers that a number of issues raised and consulted on as part of the suspended 2009 threshold reset process are relevant for the reset of the DPP. We support this conclusion. Significant effort has already been applied by both the EDBs and the Commission to resetting the regulatory price and quality standards against which EDBs will be assessed for the next regulatory period. The December 2007 Threshold Reset Discussion Paper and subsequent consultations raised a number of issues which are relevant to the DPP reset, and we trust the Commission has considered our responses to these, and subsequent papers in forming its views. We trust that the issues we have raised in the past in this context will have been considered and reflected in the DPP Reset Discussion Paper.

### **Rates of Change for the Price Component of the DPP**

9. Section 53P(6) of the Act specifies that rates of change for EDBs under the 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.*
10. Accordingly the Paper indicates that the Commission's initial views on the rates of change for the price component of the DPP for EDBs are:
- to use a CPI-X based approach
  - the X factor to be based on Total Factor Productivity (TFP) analysis
  - the lack of 2008/09 disclosure data prior to the end of August 2009 may constrain the TFP analysis able to be performed within the DPP reset timetable
  - international data will not be employed for the purpose of productivity analysis
  - the Commission will consider alternative price indices (to the CPI), but notes the alternatives available may not be sufficiently robust or stable for this purpose.
11. We support the DPP reset to be specified in the form CPI-X (subject to our further discussion on the use of the CPI below). It would be useful for the Discussion Paper to include a description as to how the Commission envisages the annual CPI-X adjustment to apply, for example to what prices, and over what periods. We are particularly interested in the timing issues that must be addressed in terms of relevant periods (ie: quarters and assessment periods) and the availability of index information, the date at which starting prices are assessed and how the rate of change is to be applied. A major concern for EDBs is the potential for breaches of the DPP due to forecasting errors, where future estimates of inflation must be made. The specification of the DPP formula will impact on the likelihood of such technical breaches. We believe the Discussion Paper should address how breaches occurring as a result of forecasting errors will be assessed, for example by use of a dead

band or under/over mechanism. This is necessary due to the potentially severe consequences of a breach of the DPP as set out in the Act.

12. We have previously submitted on productivity measures during the 2007/08 consultations on the threshold reset. We note that the Commission provided information on its assessments of productivity factors in its June 2008 Threshold Reset 2009 Methodology Update Paper and at that time identified a number of issues it intended to consider further to address issues raised by submitters about measuring productivity and setting productivity improvement targets. We anticipate a number of these issues will be addressed in the Discussion Paper and look forward to responding to this in due course. TFP is a complex methodology and it is important for the analysis and the data used to be robust and adequately tested before committing to its application.
13. We note that the global and local economic climate is undergoing significant change at the moment which will impact on input prices and the ability for EDBs to achieve productivity improvements. Accordingly past economic performance may not be an appropriate indicator of future performance, and we believe that careful consideration of this is required in resetting the DPP.
14. We also note that given the importance of the inflation indexes to the DPP, industry specific indexes could be created in order to meet these requirements if those that currently exist are not deemed to be appropriate. We therefore support the planned investigation of alternative indices as outlined in the Paper.

#### **Starting Prices for the Price Component of the DPP**

15. Section 53P(3) of the Act stipulates that starting prices should be specified as either:
  - (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.*
16. Having considered the timetable, the parallel work stream on input methodologies and the submissions made to date on these issues, the Commission considers that option (a) (prices that applied at the end of the preceding regulatory period) should apply for the DPP reset. Following the publication of input methodologies, the Commission proposes to assess EDB returns at that time and make appropriate  $P_0$  adjustments to these prices (with claw back) where required.

17. As previously submitted, we support the proposal to defer any potential  $P_0$  adjustments until after the input methodologies have been determined. This will avoid the uncertainty associated with the potential for two  $P_0$  adjustments should initial adjustments be made before input methodologies are determined. We acknowledge that this will allow more time for the Commission to consider and determine a methodology to achieve this, including consideration of future profitability. We are concerned however at the uncertainty the potential claw back arrangements create for EDBs which is contrary to the objectives of the Commerce Amendment Act 2008 to improve certainty for regulated businesses. The worst case scenario for EDBs is that some of the revenues earned from 1 April 2010 onwards may not be able to be retained. It would be helpful if the Commission were to include in the Discussion Paper, how it proposes the claw back arrangements would be implemented, for example over what period, and whether constraints were to be developed to limit the magnitude of the claw back to apply to any prior period and to be made within any one year. We understand the ENA is developing suggested guidelines for potential claw backs to assist with this, to be submitted as soon as possible for further consideration.
  
18. The Paper does not specify how the starting prices under option (a) would be determined. We submit that the starting prices should be the actual prices (as defined in the Commerce Act (Electricity Distribution Thresholds) Notice 2004) posted by each EDB as at 31 March 2009. These are the prices that applied at the end of the preceding regulatory period. They will differ to the average prices implicit in the initial DPP where EDBs are currently pricing above or below their Allowable Notional Revenue threshold (after allowing for pass through costs) as defined in the Thresholds Notice. Those which have increased prices above their initial DPP, and for which the Commission has not taken any remedial action, will continue to be assessed against their actual prices (subject to the annual CPI-X adjustment). If following future profitability assessments, the Commission deems these prices to be excessive, the claw back provides the mechanism for resolving this. If EDBs are unable to maintain their current prices they may apply for customised terms.
  
19. In order for the EDBs to understand the impact of the proposals as early as possible, it will also be necessary for the Discussion Paper to include a description as to how the Commission will assess future performance against the opening prices and rates of change to be determined. This will include how prices will be converted to allowable revenue (for example) and the related specification of quantities and pass through costs. As noted above, it will also require consideration of the availability of information, such as indexes, and the periods against which these will be assessed.

**Quality Standards for the Quality Component of the DPP**

20. There is very little guidance for the Commission in the Act in respect of how the quality standards are to be set for the DPP. Our submission on the Regulatory Provisions Discussion Paper<sup>2</sup> provided a number of comments on the practical implementation of quality paths. In addition, we submitted that the importance of quality in the context of the DPP justifies its inclusion as an input methodology and that this is possible under section 52T(1) as the list of input methodologies provided for in this clause is not exhaustive.
21. We agree with the proposal that for the purpose of the DPP reset, quality will be assessed on the basis of reliability of supply and SAIDI and SAIFI will be the primary measure of quality for this purpose. We are pleased that the Commission has acknowledged our concerns about the implications of potential technical breaches of quality paths, given the more significant penalties which will apply if DPP paths are breached.
22. Reliability performance is not a direct reflection of the behaviour of an EDB as it is influenced by external factors and is subject to variability over time. We therefore support the intention to undertake more work in this respect, to better define the measurement of reliability, and how this is incorporated into the DPP.
23. We are also encouraged by the acknowledgement in the Paper that the “no material deterioration in quality” is the appropriate benchmark for assessing regulated business quality performance under the DPP.
24. We note that section 53M permits the Commission to prescribe quality standards in any way it deems appropriate and that it refers to targets, bands or formulae. We believe it will be necessary for a new approach to defining quality to be considered for the reasons outlined above, and note that the legislation now provides for this. Reliability data must be managed in a statistically robust way for the purposes of the DPP. We understand the ENA has commissioned experts to consider possible solutions to this and expect that this work will greatly contribute to resolving this issue.
25. We have also submitted previously on the Commission’s approach to determining extreme events for the purpose of assessing reliability performance.<sup>3</sup> This was derived for the purpose of the threshold, which was a screening mechanism subject to further investigation. We

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<sup>2</sup> PwC Submission to the Commerce Commission on the Regulatory Provisions of the Commerce Act 1986 Discussion Paper, 16 February 2009

<sup>3</sup> PwC, Submission on the Draft Supplementary Guidelines for Investigating Breaches of the Reliability Criterion of the Quality Threshold, 15 June 2007

believe this will require review as quality regulation is no longer a threshold and compliance with it is mandatory.

26. The Paper indicates support in principle for an S-factor incentive mechanism for improvements in quality but proposes that this will not be feasible to develop and implement within the time available. The proposal is that this issue is considered as part of a subsequent reset.
27. We are keen to explore the possibility of including a link between price and quality to ensure that the price quality trade-off is reflected where appropriate. In principle, if consumers demand and receive stepped improvements in quality then prices should reflect this. The potential magnitude of this would be dependent on how the prices and reliability standards are set for the DPP. We suggest that the Commission should consider undertaking more work on this over the next 18 months, with a possibility of introducing such a mechanism at the same time potential  $P_0$  adjustments are introduced within the current regulatory period. This would have the advantage of postponing the implementation until after the imminent DPP reset (to be published by 1 December 2009) thus making the DPP reset as simple as possible given the time constraints, and would ensure EDBs did not have to wait a further five years before such an incentive became available to those wishing to pursue it.

### **Energy Efficiency**

28. Section 54Q of the Act specifies that 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.*
29. The Paper indicates that the Commission considers that all the mechanisms relating to Part 4 of the Act (information disclosure, DPP and customised price-quality paths (CPP)) need not individually achieve the aims of section 54Q, but that the regime as a whole should, when applied to EDBs. In particular the Paper suggests that as the DPP is proposed to be a relatively simple mechanism, and the required information may not be readily available, then energy efficiency may be better addressed through CPPs and information disclosure. The Paper also indicates that the Commission intends to seek further views from EDBs on this topic.
30. We are concerned that the proposed approach does not adequately reflect the intention of section 54Q which is to both promote incentives and avoid imposing disincentives on energy efficiency (including energy losses) and demand side management. By ignoring these issues in resetting the DPP, arguably the objectives of section 54Q are not met, for example a simple

approach to the DPP may effectively impose disincentives on such investment. Accordingly we believe that section 54Q requires the Commission to consider, for each of its information disclosure, DPP and CPP mechanisms, whether incentives or disincentives have been created for energy efficiency. We therefore do not support the proposal to ignore section 54Q for the purpose of the DPP reset.

31. We understand the ENA is considering this topic in more detail at present and will be submitting more information for the Commission and EDBs to consider as soon as possible.

**General**

If you have any queries in relation to this submission, please contact:

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