

**Submission on the
Process & Issues Paper on the DPP Reset**

From the Electricity Networks Association

15 April 2009

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1. Introduction

1. This submission, from the Electricity Networks Association (ENA), is in response to the Commerce Commission's Process & Issues Paper¹ on the reset of the default price/quality path (DPP) applying to electricity distribution businesses (EDBs).
2. The Process & Issues Paper invites comment on the Commission's proposed process to reset the DPP and its initial views on a number of issues related to the reset. This approach by the Commission to engage with the sector early in the reset process is consistent with that requested by the ENA in its submission of 16 February, and the ENA recognises and appreciates this positive development.
3. As the time allowed for submissions is short, we have noted in relation to some topics where the ENA is undertaking further work, and we will be submitting this material to the Commission once it is completed (in some cases by early May)
4. ENA's contact person for this submission is:

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5. The submission is ordered as follows:
 - Reset process
 - Starting prices
 - Rate of change in prices
 - Quality standards
 - Energy efficiency

¹ *Default/customised price-quality regulation: Reset of default price-quality path for electricity distribution businesses: Process and issues paper*, Commerce Commission, 30 March 2009

Summary of submission

6. The key points of this submission are the ENA:

On the reset process

- considers the Commission should hold a conference as part of the Discussion Stage, and also plan to hold one as part of the Decision Stage (the need for the latter one could be re-assessed closer to the time and depend on the degree of alignment at that stage).

On starting prices

- considers the starting prices to apply from 1 April 2010 should be the “prices” for the regulated service as defined in the Thresholds Gazette Notice, as at 31 March 2010.
- considers it important that prices are reset in such a way as to allow EDBs to change relative prices within regulatory periods.
- supports the Commission’s second approach to determining “starting prices”, which would involve at most a single P_0 adjustment (if any).
- considers the Commission should define, in advance of completing the reset of the DPP, the principles it would use to apply any “claw-back”, to reduce the level of uncertainty with respect to this possible process and its likely outcomes.
- intends to develop principles for claw-back decision-making and submit them to the Commission by early May.

On rate of change in prices

- supports a CPI – X mechanism for indexing the rate of change in prices.
- cautions the Commission against dismissing at this stage the use of international data in any total factor productivity (TFP) analysis, as it may in practice be the most robust dataset and the data that are most readily available.
- intends to provide a more comprehensive response on TFP issues, once it has undertaken further work on this topic.

On quality standards

- supports the approach proposed by the Commission with respect to developing quality standards, including the recognition of EDB's concerns with respect to potential "technical breaches" under the DPP.
- intends to submit further material by early May on the project it has underway to develop appropriate ways to measure and monitor quality standards. The RWG will contact Commission staff to discuss the scope and nature of this work, in order to ensure it is aligned as far as possible with issues the Commission wishes to see addressed in this area.

On energy efficiency

- considers the Commission should treat the 54Q requirement as a mandatory test for any actions it takes under Part 4 with respect to electricity lines services. The ENA intends to propose principles or tests the Commission could use to apply this requirement, and to also provide practical examples of the opportunities EDBs face in terms of energy efficiency initiatives and ways in which Part 4 could be implemented to be compliant with the 54Q requirements.

2. Reset process

7. The ENA agrees that the timetable for resetting the DPP is short. This suggests the need for a reset process that is relatively straightforward, and is based on information that is ready to hand. The recommendations in this submission reflect this view.
8. The process outlined in paragraphs 10 to 18 of the Process & Issues Paper does not include any conferences or workshops. We consider written communications are not a substitute for the face to face communication achieved in workshops and conference. The ENA recommends the Commission holds a conference as part of the Discussion Stage, and also plans to hold one as part of the Decision Stage (the need for the latter one could be assessed closer to the time and depend on the degree of alignment at that stage). We note it is in the interests of the Commission and EDBs that the reset DPP minimises the need for EDBs to opt for customised price/quality paths, and to this end the reset process warrants substantial investment from all parties involved

3. Starting prices

9. Part 4 of the Commerce Act requires the Commission to reset starting prices at the beginning of a regulatory period as follows (clause 53P (3)):

(3) The starting prices must be 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.

(4) Starting prices set in accordance with subsection (3)(b) must not seek to recover any excessive profits made during any earlier period.

10. The Commission suggests the following two possible approaches to resetting the DPP (paragraph 29), and states an initial preference for the second approach. The two approaches are:
1. *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.*
 2. *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.*
11. The ENA considers the main difficulty with the first approach is that the input methodologies required to implement it will not be finalised by the Commission until about mid 2010, much too late for this immediate task. Thus in the interim this first approach would require the Commission to use input methodologies that had not been finalised. Such an approach would run counter to the intent of the discipline in Part 4 to sequentially first develop and then apply input methodologies, and would be a retrograde way for the Commission to commence the implementation of Part 4.
12. In addition, we question whether the Commission has the resources to complete the first approach in time, across all non-exempt EDBs, as the Commission's timetable requires it to publish draft decisions by September 2009.
13. The ENA supports the use of the second approach to determining starting prices. The Commission is clearly right that it is desirable in this transition period to avoid two P_0 adjustments. In this context, the ENA raises two issues for clarification:

- that the “*prices that applied at the end of the preceding regulatory period*” be the “prices” for the regulated service as defined in the Thresholds Gazette Notice as at 31 March 2010.
- that the Commission define in advance of completing the reset of the DPP the principles it would use to apply any “claw-back”.

14. Each point is discussed below

Definition of starting prices

15. The Commission does not indicate in its Process Paper how the “*prices that applied at the end of the preceding regulatory period*” should be defined. The choice of the “starting price” in this reset is unique as it involves the transition from the Part 4A regime to Part 4.
16. Section 54j (2) (a) deems the “thresholds” to be section 52P determinations that “*apply those thresholds to each supplier as if the thresholds were default price-quality paths*”. However, the thresholds as gazetted in the Thresholds Gazette Notice² are not a defined price, but rather an “allowable revenue”. Further, under the thresholds regime an EDB is able to lawfully price such that the “allowable revenue” amount is breached, and the Commission has the ability to launch an investigation and, if it considers appropriate, control the EDB and require it to reduce its prices.
17. This reset is part of the transition that moves EDBs from the thresholds regime to the Part 4 regime under which it is unlawful for EDBs to raise prices above those determined under this reset. Thus the context of this reset is quite different to future resets under Part 4, in which the “starting price” will be the price allowed under the previous reset. The Commission needs to find a way to navigate this transition in a manner that reflects the intent of Part 4 and the differences between it and Part 4A.
18. In our view the best way to navigate this transition is to define the “starting price” as what an EDB in practice charges, which is defined in the Thresholds Gazette Notice as (clause 3):

price means—

(a) a posted price in nominal terms (such as a tariff, fee or charge) or a component thereof, that a distribution business charges in relation to a

² *Commerce Act (Electricity Distribution Thresholds) Notice 2004, Pursuant to Part 4A of the Commerce Act 1986, 31 March 2004*

specified service (and which may include discounts, provided those discounts are disclosed in accordance with Part 6 of the Requirements), but does not include—

(b) any amounts described in paragraph (b) of the definition of pass-through costs [note this relates to pass-through costs that the EDB has passed on transparently to its customers and/or electricity retailers]

19. This definition of price is used in the Thresholds Gazette Notice to calculate an EDB's "notional revenue" under clause 5(1).
20. The advantages of using this definition of "price" include:
 - it is already known and understood by EDBs and the Commission, and would therefore be straightforward and feasible to implement on the Commission's proposed timetable.
 - it would require at most one P_0 adjustment (once input methodologies have been determined) rather than possibly two adjustments if the Commission's first approach were used.
 - it would allow those EDBs that have breached their price thresholds intentionally, in order to obtain a reasonable return on their investments, to continue to use those prices under the reset DPP.
 - it would enable the Commission to focus its efforts in relation to determining DPP prices on only those EDBs that it considers warrant attention. The Commission retains the ability under Part 4A to inquire into any thresholds breaches in the 2009/10 year it considers unreasonable, and if necessary set other prices for that EDB. Alternatively, once the Commission has completed its input methodologies, it has a 9 month window within which it may reset the DPP and apply claw-back.
21. It is important to note that EDBs have strong incentives to not breach thresholds in the 2009/10 year (by for example raising prices prior to 31 March 2010) unless they are confident such prices could be substantiated in the context of a Commission investigation, as such breaches are to be handled under the Part 4A regime, not Part 4. Part 4A does not have the procedural rigour of Part 4 and therefore, from an EDB perspective, is a much inferior regime to be subjected to. Thus there are good reasons why EDBs would not raise their prices unreasonably, if the above approach to the definition of "starting price" were used. However, if they did raise their prices, the Commission has the ability under Part 4A and Part 4 to address any concerns it has in relation to such prices.
22. We also note that starting prices will need to take into account any shifts in transmission prices that occur as from 1 April 2009. Under the thresholds regime

such shifts were allowed for by treating transmission prices as a “cost pass through”. There will need to be some similar mechanism under Part 4.

23. Lastly, the thresholds regime provided for an EDB to change relative prices for regulated services within a regulatory period (and not breach its thresholds) provided it could demonstrate that any such change of itself did not create an increase in revenue (clause 5 (2) of the Thresholds Gazette Notice). This provision provided important pricing flexibility and it will be even more important (given that it will be unlawful for EDBs to raise prices above the reset DPP) that some similar mechanism is incorporated in this reset. In addition, the Electricity Commission has begun consulting on model distribution pricing methodologies, with a view to promoting the adoption of these over the next few years. Such adoption will likely require some flexibility in pricing.

Principles to apply claw-back need to be defined in advance

24. The meaning and application of claw-back under Part 4 is as follows:

52D Meaning and application of claw-back

(1) A reference to the Commission applying claw-back is a reference to the Commission doing either of the following:

(a) requiring a supplier to lower its prices on a temporary basis in order to compensate consumers for some or all of any over recovery that occurred under the prices previously charged by the supplier:

(b) allowing a supplier to recover some or all of any shortfall in its revenues that occurred under the prices previously charged by the supplier.

(2) If the Commission requires a supplier to lower its prices, it must also require that the lowering of prices must be spread over time in order to minimise undue financial hardship to the supplier.

(3) If the Commission allows a supplier to recover any shortfall, it must require that any recovery must be spread over time in order to minimise price shocks to consumers.

25. The Commission is able to use claw-back in three instances under Part 4 with respect to electricity lines services:
- it may use claw-back when determining customised price-quality paths (s 53V)

- it must use claw-back under certain circumstances if an input methodology is changed on appeal (s 53ZB)
 - it may use claw-back when resetting the DPP subsequent to publishing the initial input methodologies (s 54K)
26. The potential use by the Commission of claw-back, subsequent to it publishing the initial input methodologies, results in uncertainty of prices for suppliers and customers for the period up to the point that the Commission determines if, and how it will apply claw-back. Further, this form of uncertainty is inconsistent with outcomes produced in competitive markets (i.e. that prices are not known for certain until some time after the service is supplied), and erodes incentives on suppliers to innovate, invest, and improve efficiency, all of which are attributes that form part of the purpose statement of Part 4 (s 52A).
27. ENA recognises the timetables set in the Act have placed the Commission under pressure, and it may be tempting to defer the development of the claw-back aspect of the regime. Development of principles to guide any claw-back decisions will not change the DPP prices, nor will they predetermine the claw-back decision – the outcome of applying the principles will only be known once the input methodologies are finalised. In that sense, a period of uncertainty prior to finalising the input methodologies is inevitable. However, one lesson to be taken from the experience of the thresholds regime is the importance of declaring principles upfront. If principles are developed first, then when the occasion arises to apply them, it is an exercise in applying considered and pre-declared principles, rather than developing principles on the run, or worse, making ad hoc decisions in the absence of principles. This sequencing of developing principles prior to their application is particularly important in an area that has the potential to be contentious, such as claw-back.
28. The ENA considers the Commission could reduce much of this uncertainty by issuing a set of principles that it would use when deciding whether or not to apply claw-back, and if so, to guide how it will apply it.
29. We have not had time to develop such principles for this submission but we will do so with the intention of submitting them to the Commission by early May.

4. Rate of change in prices

30. The relevant Part 4 clauses for setting the rate of change in prices is as follows (from 53P):

(5) Subject to subsection (8), the Commission must set only one rate of change per type of regulated goods or services (for example, if the rate of

change (x) is 1% in a CPI-x path, 1% must be the rate for all goods or services of that type).

(6) The rate of change must be based on the longrun 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.

(7) When setting the rate of change, the Commission may take into account the effects of inflation on the inputs of suppliers of the relevant goods or services.

(8) The Commission may set alternative rates of change for a particular supplier—

(a) as an alternative, in whole or in part, to the starting prices set under subsection (3)(b) if, in the Commission's opinion, this is necessary or desirable to minimise any undue financial hardship to the supplier or to minimise price shock to consumers; or

(b) as an incentive (under section 53M(2)) for the supplier to improve its quality of supply.

(9) Any alternative rates of change set under subsection (8) may include step changes.

31. The Commission suggests the following approach to setting the rate of change in prices (paragraph 24).

1. *a CPI-X based approach should form the basis of the price-path within the DPP;*
2. *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;*
3. *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);*
4. *the option to use international data for suppliers in other comparable countries for the purposes of productivity analysis will not be employed; and*

5. *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.*
32. On point 1, the ENA supports a CPI – X mechanism for indexing the rate of change in prices.
33. On point 4, the ENA cautions the Commission against dismissing at this stage the use of international data, as it may in practice be the most robust dataset and the data that are most readily available.
34. We have not had the time to develop a more comprehensive response on TFP issues but we plan to do so and will be submitting further material on this once completed.

5. Quality standards

35. The relevant Part 4 clauses with respect to quality standards are as follows (s 53M (3) and s 53P (8) respectively):
- (3) Quality standards may be prescribed in any way the Commission considers appropriate (such as targets, bands, or formulae) and may include (without limitation)—*
- (a) responsiveness to consumers; and*
- (b) in relation to electricity lines services, reliability of supply, reduction in energy losses, and voltage stability or other technical requirements.*
- (8) The Commission may set alternative rates of change for a particular supplier—*
- (a) as an alternative, in whole or in part, to the starting prices set under subsection (3)(b) if, in the Commission’s opinion, this is necessary or desirable to minimise any undue financial hardship to the supplier or to minimise price shock to consumers; or*
- (b) as an incentive (under section 53M(2)) for the supplier to improve its quality of supply.*
36. The Commission’s initial views in the Process & Issues Paper are that (paragraph 35):
1. *reliability of supply will be the focus of quality standards under the DPP;*

2. *SAIDI and SAIFI continue to be used to specify and monitor reliability of supply;*
 3. *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*
 4. *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.*
37. The ENA agrees with this approach with respect to quality standards and, as indicated to the Commission already, is undertaking work on developing an appropriate way to measure and monitor quality standards that addresses the issues raised in point 3 above. The RWG will contact Commission staff to discuss the scope and nature of this work, in order to ensure it is aligned as far as possible with issues the Commission wishes to see addressed in this area. We intend to provide an update to the Commission on this project by early May.

6. Energy efficiency

38. The relevant Part 4 clause with respect to requirements on the Commission in relation to energy efficiency is 54Q, as follows:

54Q Energy efficiency

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.

39. The Commission provides some initial thoughts on the implications of this requirement (paragraphs 40 to 42) and seeks further views from EDBs on potential incentives and disincentives to investment in energy efficiency, and particularly in relation to demand side management.
40. The ENA notes the following in relation to the 54Q requirement:
- this requirement is to both *promote incentives* and *must avoid imposing disincentives*, and the Commission's actions must comply with both tests.
 - the incentives relate to "*suppliers of electricity lines services to invest in energy efficiency and demand side management, and to reduce energy*

losses". Notably, the subject of the test does not include others in the value chain (e.g. retailers, generators and transmission), or end consumers.

- the requirement is on the Commission, when it is applying Part 4 to electricity lines services, and does not provide the Commission the discretion to comply with this requirement in some instances but not in others.
41. Thus in ENA's view the Commission should treat this requirement as a mandatory test for any actions it takes under Part 4 with respect to electricity lines services. The starting point for the application of this requirement needs to be clarified. Part 4 appears to require the energy efficiency provisions to take effect from the initial application of Part 4 (i.e. from April 2009). Thus this requirement must be a test that applies to resetting the DPP, any claw-back decisions, and so forth.
42. The ENA intends to propose principles or tests the Commission could use to apply this requirement, and also provide practical examples of the opportunities EDBs face in relation to energy efficiency initiatives and ways in which Part 4 could be implemented to be compliant with the 54Q requirements.