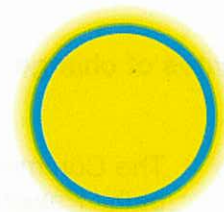


15 April 2009

David Healy
Chief Advisor
Network Performance Branch
Commerce Commission
Wellington
[By email]

POWERCO



Dear David

Powerco's submission to *Reset of Default Price-Quality Path (DPP) for Electricity Distribution Businesses: Process and Issues Paper*

Executive summary

1. This submission contains Powerco's response to the Commission's Process and Issues Paper, published on 30 March 2009. Powerco welcomes the introduction of a "discussion stage" and appreciates the opportunity to comment at an earlier stage than normal in the Commission's thinking. The DPP is the first major implementation stage of the Commerce Amendment Act 2008 and it is important that there is a credible development process with an appropriate end result to support the new regime.
2. The Default Price Path ("DPP") will also influence the extent to which lines businesses can continue with their planned investment, investment which can help provide much needed economic stimulus in the current economic climate. The DPP reset will impact on investment at a critical part of the economic recovery process and it is important to set prices appropriately.
3. In summary Powerco supports the general direction of the paper and for most of the proposals to be developed further in the May Discussion Paper. The DPP time constraint seems to have been an important consideration in most of the Commission's decisions. Powerco supports this approach as it is essential that the new regulatory regime has time to be properly developed, and this should not be hindered by the challenging timeframe for implementation of the DPP.
4. Energy efficiency is a good example of where rushed regulation could do more damage than good. It is better to adopt a "do no harm" approach now, and take time to develop more complex technical parts of the regime later.

5. Powerco does have some concerns about three of the Commission's initial views and recommends that:
 - the use of international data in the Total Factor Productivity (TFP) analysis not be ruled out until the robustness and credibility of New Zealand data is fully understood
 - the inclusion of industry input prices in the X factor is not ruled out until further analysis takes place on their merit and volatility
 - the method of claw back related to any P_0 adjustment is defined in advance.

Rates of change

6. The Commission has proposed a CPI-X based approach as the basis of the price path. Powerco supports this approach and it is consistent with the approach taken by regulators internationally.
7. The Commission has stated that Total Factor Productivity (TFP) analysis is its preferred method to inform the level of the X-factor. Powerco is considering the benefits and issues of various approaches to measuring productivity and will provide more detailed comments in response to the Commission's May Discussion Paper. (This is an example of where the discussion stage allow interested parties more time to consider the Commission's proposal and better understand the impacts on its business.)
8. The Commission is likely to take the country-wide drive for efficiency into account in determining the economy TFP. Powerco recommends the Commission is cautious in what it asks lines companies to do in addition to the country-wide productivity improvements. Powerco has already made significant productivity gains over the last five years under its X factor of 2. Requiring a similar saving in addition to efficiency changes that naturally occur due to the recession will be very difficult. The majority of productivity savings are made by long-term capex challenges. Powerco is limited by what it can achieve in the short-term.
9. The Commission has stated that it will not use international data for suppliers in other comparable countries for the purposes of productivity analysis. In our submission in February 2009 we mentioned a number of issues with finding a suitable international comparator to the New Zealand electricity sector, and that using international data can be risky. Powerco does note that there are risks with the level of information available in New Zealand to perform TPF analysis. Powerco recommends that international data should not be ruled out until the robustness and credibility of New Zealand data is fully understood.
10. Section 53P(7) of the Commerce Act allows the Commission to take into account the effects of inflation on the inputs of EDBs when setting rates of change. The Commission states that it has considered price indexes alternative to the CPI, such as the Producer Price Index, Labour Cost Index and Capital Goods Price Index, but that it considers that these may not be sufficiently robust or stable and that the use of an excessively volatile index may lead to technical breaches.
11. Powerco believes that there is a strong conceptual argument to reflect differences of input prices between the electricity distribution sector and the overall economy in the X factor. The issue the Commission has raised on volatility is an implementation issue and we recommend that a more detailed

assessment of the volatility of input price indexes is carried out before their inclusion in the X factor is ruled out.

Starting prices

12. The Commission has outlined a number of issues with making a Po adjustment on 1 April 2010. This includes the disruption to consumers and EDBs of potentially two Po adjustments and the lack of information available.
13. The Commission has not detailed its thinking on what the “prices that applied at the end of the preceding regulatory period” should be. In our view this price should be what an EDB in practice charges, which is defined in the Thresholds Gazette Notice¹ 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 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

14. This definition of price is used in the Thresholds Gazette Notice to calculate an EDB’s “notional revenue” under clause 5(1). The desirability of using this definition of price is that it is already known and understood by EDBs and the Commission, and would therefore be straight forward to implement.
15. Powerco also has concerns on the method of claw-back that could be used. An inappropriate approach to claw back could undermine investor confidence and reduce supplier incentives to innovate, invest and improve efficiency. Powerco understands that the ENA is planning to recommend to the Commission a set of principles on regulation that will set a framework for determining how claw back should be applied.
16. In conclusion, Powerco agrees with the Commission’s proposal that starting prices should be specified as those applying at the end of the preceding regulatory period, on the condition that:
 - the “prices that applied at the end of the preceding regulatory period” be defined as the prices charged by the EDB as at 31 March 2010; and
 - the Commission define in advance of completing the reset of the DPP the method it will use to apply any “claw back”.

Quality standards

17. Powerco agrees with the Commission that measures of quality should assess any underlying deterioration of reliability of supply, and that SAIDI and SAIFI are appropriate as they are internationally accepted measures of reliability.

¹ Commerce Act (Electricity Distribution Thresholds) Notice 2004, Pursuant to Part 4A of the Commerce Act 1986, 31 March 2004

18. The key issue, as the Commission recognises, is how the quality threshold is determined. In our submission of 16 February 2009, we described the issue of inherent volatility in measuring quality and the heightened implications of non-compliance under the DPP. Powerco agrees with the Commission that the concerns of lines businesses in respect of potential technical breaches under the DPP are valid, and that the Commission should seek to work with EDBs to develop appropriate quality standards.
19. Powerco is contributing to the work by ENA in investigating statistical variability of reliability performance, and considers this approach a constructive and positive way for lines businesses to support the Commission in determining reliability thresholds.
20. Powerco supports exploring a S factor mechanism and is keen to work with the Commission to develop an effective tool which puts the appropriate incentive mechanisms in place. Powerco understands the time pressures on the Commission and agrees that it would be risky to try to develop a S-factor quickly. This is another example of how the DPP regime should evolve over time, with the possibility of a S factor being part of the next regulatory re-set.

Energy efficiency

21. Powerco supports the Commission's prudent approach to developing incentives to promote energy efficiency. The Commission and lines businesses have a common goal in this area and there is much potential to work together to create workable commercial incentives to improve energy efficiency. There is also much risk of poor, rushed regulation that wastes resources and has little impact.
22. Powerco does not believe there is much opportunity for improving energy efficiency by trying to reduce electricity losses. For example, installing a low loss transformer has a high capital cost but a negligible impact on line losses. Reconfiguring the network to optimise the loads of lines could have a more noticeable impact on losses, but again the cost would be substantial. It seems more sensible for incentives in this area to focus on new capital expenditure (eg in the way engineers configure new networks).
23. Powerco also agrees that it will be difficult to find robust information on losses. Powerco for example, can not measure losses for its Western region as we do not hold data on the electricity that is supplied to each ICP. Powerco instead bills according to electricity that exits a Grid Exit Point (GXP). While this may be seen as an issue, the GXP pricing methodology includes a demand charge which is a better mechanism for signalling that consumers should avoid electricity use in peak times, and hence improving energy efficiency.
24. Powerco agrees with the Commission that the Part 4 regime as a whole should encourage energy efficiency, rather than just the DPP scheme. Powerco submitted in February 2009 that the relationship between lines business revenue and energy use would have to be de-coupled in some way if lines businesses were to actively promote demand-side management. This is a complex area and a cautious approach to policies should be taken. For example, the Commission could trial a mechanism to promote demand-side management with a lines business as part of a customised price path, before attempting to roll out the scheme to all lines businesses.

25. Thank you for taking these comments into account. If you wish to discuss any parts of this submission in more detail please contact me on 06 759 6216.

Yours sincerely

A handwritten signature in blue ink that reads "Goodeve". The signature is written in a cursive style with a large initial 'G'.

Paul Goodeve
Regulatory and Business Manager