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Submission on Reset of Default Price-quality Path for Electricity Distribution Businesses, Process and Issues Paper

Introduction

1. Vector welcomes the opportunity to submit on the Commerce Commission's consultation paper, Reset of the Default Price-quality Path for Electricity Distribution Businesses, Process and Issues Paper of 30 March 2009.
2. The process and issues paper marks a welcome step in the process of engagement on specific aspects of how the default-price path (DPP) will be implemented. We are strongly supportive of the Commission providing an indication of its thinking at a preliminary stage, as it provides a basis for the industry to progress its thinking in parallel and provide constructive input at an early stage of the process.
3. Vector appreciates the large amount of work that the Commission needs to undertake over the course of the year in order to meet the requirements of the Commerce Act. Vector continues to encourage the Commission to take advantage of opportunities to engage with industry through informal channels, such as work shops on specific issues, throughout the process.
4. Although Vector agrees with many of the initial conclusions put forward by the Commission in the paper, Vector considers that the new requirements of the Act require the Commission to give more thought to the desirability of having additional incentive mechanisms in the DPP. This would be consistent with the new purpose statement which puts greater emphasis on the need to promote incentives to invest and innovate. In particular, Vector would like the Commission to put more resource into considering the development of an S-factor to provide incentives for quality improvements. Vector also considers that a more thorough

analysis of the way price-quality regulation impacts on incentives to invest in energy efficiency and demand side management is needed to meet the requirements of S54Q. Five years is a long time to miss out on the potential benefits of enhancements to quality or the promotion of energy efficiency.

5. Vector continues to stress the need for greater certainty in regulatory settings. This is particularly important to any potential adjustment to starting prices. In Vector's view, given the requirements of the Act, certainty would best be promoted if the Commission clearly specified the criteria on which they intend to make adjustments to starting prices well in advance of making such adjustments. To not do so creates considerable uncertainty for industry, potentially until late 2011.

6. Our response to the issues paper follows the structure of the Commission's paper.

Process Issues

7. Vector notes that under the timetable proposed by the Commission, a final decisions paper will be issued in mid-November and a "short consultation" on this paper will also be undertaken in mid-November with determinations issued at the end of November.

8. It is important that businesses have an opportunity to fully review and comment upon the final decisions paper in order to avoid any unintended consequences. Vector considers a period of two weeks would be required to provide comments on the final decisions paper and would like to see this built into the timetable. Allowing businesses two weeks to consider the final decisions paper suggests that cross submissions on the draft decisions paper would need to be due in mid-October and hence that the draft decisions paper will need to come out towards the start of September. The sequencing will need to recognise the complexity of any final proposals: in the event that the final proposal is complex, then more time will be needed to ensure that the outcomes are effective.

9. Vector suggests that the Commission put more specific dates on when papers are due for consultation in order to ensure that the industry has its own resources available to meet the consultation timeframes.

10. Several submission's on the Commission's December discussion paper, Regulatory Provisions of the Commerce Act (December paper), argued that it will be difficult to resolve a number of complex issues related to the new framework

through large, formal consultation processes when industry and the Commission have not engaged informally to reach a common understanding of the issues. Several EDBs suggested the establishment of informal working groups to address issues such as productivity, quality standards and approaches to energy efficiency. While the industry can be proactive in providing input into the process (e.g., the initiative to provide statistical input on measuring quality performance), until we can understand the Commission's thinking and the issues it considers are relevant it can be difficult to identify where the industry can best provide our input. Vector supports the proposal of the Electricity Networks Association (ENA) that the Commission holds a conference as part of the Discussion Stage on the DPP, and also plans to hold one as part of the Decision stage.

Rates of change

Productivity

11. Vector agrees with the Commission that total factor productivity (TFP) analysis is the appropriate approach to assess the long-run average productivity improvement rate for electricity distribution businesses (EDBs). Productivity is very difficult to measure for the EDB sector. Estimates of productivity undertaken by Meyrick and Associates reduced significantly from 2003 to 2007, from 2% to 0.9%¹. This indicates to Vector that estimating productivity from the limited data available in New Zealand without appropriately adjusting for irregularities in the data can result in a measure which differs significantly from the true productivity measure.

12. Key issues to resolve in measuring productivity include understanding anomalies in the data and understanding the impact of the business cycle on productivity. For example, the analysis undertaken by Meyrick and Associates has been criticised for not sufficiently taking account of data anomalies. These anomalies include the apparent "TFP surge" measured in 2000, which was largely the result of the change in the policy regime that year, and lack of stability in the operating expenditure series arising from the change in ownership of the UNL network.² Second, changes in the global environment at present may reduce productivity over coming years through increases in input prices and decreases in network utilisation. As the current measure of productivity only includes data from

¹ Meyrick and Associates (2007), *Electricity Distribution Business Productivity and Profitability Update*, Report prepared for the Commerce Commission.

² Pacific Economics Group (2008), *Productivity and Profitability Analysis for Updated Thresholds Regime: Evaluation*.

the long period of economic upswing which we have experienced over most of this decade, but does not include data from the period of economic downturn which we are now experiencing, it is likely to be a poor measure of 'long-run' productivity and an inappropriate measure of productivity over the next three to five years.

13. These issues imply that the Commission needs to exercise judgement when determining the productivity rate to include in the DPP. Vector submits that the Commission should err on the side of caution in establishing a measure of productivity over the next regulatory period, in order to ensure that businesses continue to have incentives to innovate and invest as required in the purpose statement.

14. Vector agrees with the Commission that the inclusion of international data when setting the rate of change would be problematic as it is difficult to adjust data such that it is comparable to New Zealand conditions. Factors such as differences in the regulatory framework, the size of firms and differences in the relative cost of labour and capital are likely to impact significantly on productivity measures. For these reasons Vector supports the Commission in not using a measure of productivity derived from international data as the rate of change in the DPP. However, Vector considers that it is important to understand international measures as a check on the reasonableness of New Zealand estimates, particularly in terms of understanding the method used to measure productivity and the drivers of productivity and hence differences between countries.

Input price inflation

15. Under S53P(7) the Commission may take into account the effects of inflation on the inputs of suppliers of the relevant goods or services. Although the Commission proposes to consider the use of alternative price indices to the CPI, it notes that a number of alternatives to the CPI may not be sufficiently robust or stable to include within the DPP.

16. Equipment suppliers continue to indicate price increases at a higher rate than CPI inflation over coming years. This implies that, should the Commission take input price inflation into account under S53P(7), the CPI cannot be used as a proxy for input inflation. Further, failure to take input price inflation into account will result in EDBs not being able to recover costs, or being forced unnecessarily to incur the likely significant costs of applying for a customised proposal.

17. Vector considers that it is important that the Commission understand:

- The drivers of input price inflation for EDBs;
- The extent to which input prices and CPI are likely to diverge over the regulatory period;
- The impact on the profitability of EDBs.

18. Once the impact of input price inflation on profitability is understood, Vector considers that the Commission should consider alternative mechanisms to take input price inflation into account in the DPP. Although Vector supports consideration being given to the use of alternative indices to the CPI to adjust starting prices, alternative mechanisms need to be considered as well. For example, forecast input price inflation could be considered when making starting price adjustments or alternatively an additional price adjustment could be made, potentially with a lag, in years in which input price inflation exceeds CPI inflation by a significant amount. These types of approaches would not lead to technical breaches as suggested by the Commission.

19. Given the specific inclusion of a reference to input price inflation in S53(P)(7), Vector would expect to see a thorough analysis of different ways in which input price inflation can be taken into account in the DPP in the May discussion paper.

Starting Prices

20. The Commission states that specification of starting prices (P_0) for individual EDBs is likely to be appropriate under the DPP given the generic nature of the X-factor. The Commission's preferred position is to set starting prices in the December 2009 determination as those applying at the end of the preceding regulatory period. Following the publication of input methodologies (between June and December 2010) a price adjustment may be made if application of the input methodologies would have resulted in a materially different DPP being set. The Commission has 9 months from the time of the input methodology determination to undertake the price reset.

21. Vector strongly supports delaying the making of a P_0 adjustment until such time as relevant input methodologies have been set. This would avoid two P_0 adjustments being made and would avoid any implication that input methodologies have been pre-determined. However, this approach leaves EDBs in a position of considerable uncertainty, potentially until late 2011, as to the revenue they can earn as of April 2010. This is despite determinations being made on the DPP in 2009. Vector has previously submitted that the Commission should take a rules based approach to making P_0 adjustments, for example by specifying the circumstances under which P_0 adjustments would be made as an input

methodology. This would create greater certainty for EDBs and therefore enhance incentives for investment and innovation.

22. Matters which the Commission need to specify include:

- The timeframe for profitability assessment. S53P(3)(b) states that starting prices may be assessed based on current and projected profitability. The Commission needs to set out the start and end point for this assessment. Vector considers that the 2008/09 disclosures provide the starting point for assessing Vector's profitability as this is the first full year for which disclosures take account of the sale of the Wellington network. This is a starting point only, however, and the 2008/2009 disclosures would not be reflective of the current recessionary conditions;
- The methodology for assessing future profitability. As the DPP is intended to provide a low cost mechanism to set price paths it would not be appropriate to require all EDBs to provide full building blocks analysis over the entire regulatory period. However, the current economic crisis is likely to result in lower reported profitability over coming years due to lower inflation and weak demand. The impact of the economic crisis on reported profitability needs to be explicitly and transparently taken into account in the DPP;
- Under S54K(3) an adjustment can only be made to account for the change in input methodology if the input methodology would have resulted in a materially different outcome. Greater certainty would be provided if the Commission specified what it considers is likely to constitute a material difference;
- The information which will be used to reset the DPP and apply claw-back. Vector considers that S54(K)(3) only allows claw-back to account for a change in input methodology, rather than a change in the information available to the Commission after the DPP has been reset.³ For example, it would not be appropriate for the Commission to claw-back higher than expected profits that are reported in information disclosed after 1 December 2009. The Commission will need to take great care in specifying the information on which the DPP

³ S54K(3) requires an assessment of what the DPP would have been had the input methodology applied at the time of the reset which takes effect before 1 April 2010.

has been set to avoid any implication that a decision to reset the DPP has been influenced by information received in the future. If EDB's perceive there is a risk that a rate-of-return methodology will apply to the year ended 31 March 2011 then there will not be incentives to improve efficiency; and

- How claw-back will be applied. Greater certainty would be provided if the Commission specified factors such as the time period over which claw-back will apply (i.e. how many years a business will have to make up for "excess" revenues due to the establishment of, or changes to, input methodologies) and the interest rate applying to the claw-back.

23. In addition, Vector supports the ENA's submission regarding the definition of prices.

Quality Standards

24. Vector welcomes the indication in the consultation paper of the Commission's current views on the introduction of quality standards. Section 53M requires each default price path to include quality standards and may include incentives for a supplier to maintain or improve their quality of supply.

25. Vector agrees with the Commission that reliability of supply should be the focus of the quality standards for the next regulatory period. Reliability is the 'component' of quality of service that is generally most important to our customers. We also agree that SAIDI and SAIFI should be used as the indicators to set and monitor reliability performance for this regulatory period. Additional components and indicators could be considered for future regulatory periods.

26. Vector strongly welcomes the Commission's agreement that quality standards should be set in such a way as to minimise technical breaches and to reflect the greater severity of the implications of a breach of quality standards under a default price path. Vector particularly welcomes the acceptance that 'dead bands' may be an appropriate means of minimising technical breaches.

27. While Vector understands the Commission's reasoning behind its suggestion to delay an S-factor incentive scheme until the next regulatory period, we strongly believe that such a deferral would miss a valuable opportunity to promote improvements in the quality of electricity supply in New Zealand.

28. Development of a highly effective S-factor incentive scheme will necessarily be a process rather than an event. We can expect that the first scheme to be implemented will experience some 'teething' problems and subsequent schemes will be refined and improved based on experience with earlier schemes. Therefore, Vector would be concerned if we did not implement a scheme in this regulatory period to gain some valuable experience as well as to start improving the quality of service provided to consumers. We believe that a workable S-factor scheme could be developed that mitigates many of the Commission's concerns. Internationally New Zealand is already well behind other parts of the world. S-factor schemes have been operating in the UK, parts of Australia and other countries for two or more regulatory periods now. Falling further behind these countries is not desirable.

29. Vector agrees with the Commission that it is unclear how much New Zealand consumers are willing to pay for an improvement in their electricity supply. However, the response to recent outages in New Zealand and feedback Vector receives from customers demonstrates that there is a desire for improved service here. Vector believes that to delay a scheme to incentivise improvements in quality because we do not have definitive knowledge about *how much* customers want quality to improve would be to mis-judge consumer demand.

30. Vector considers that the best way to mitigate the risk that quality improvements are made which customers did not want is to introduce the scheme in a way which makes the impact on prices relatively small for the first regulatory period. One way to do this would be to set a relatively conservative cap on the amount of revenue at risk/earned under the plan. Then a survey on consumer demand and willingness to pay for quality improvements should be conducted in advance of the next regulatory period.

31. The ENA is developing proposals for an S-factor scheme to be implemented in this coming regulatory period which will be presented to the Commission shortly. Given the tight timeframes available and because it would be the first S-factor incentive scheme to operate in New Zealand, this proposal will be relatively simple. We believe we should implement a straightforward scheme focusing on core reliability measures in this regulatory period. A modest scheme implemented in this regulatory period could be refined and improved in the next regulatory period. Consideration could also be given to whether it would be possible to delay the commencement of the scheme for a year (for example specifying the mechanism as an input methodology so it could be implemented with the Po adjustment), rather than five years, if data issues prevent immediate implementation.

32. Vector recommends the Commission consider the ENA proposal carefully and use it as the basis for introducing an S-factor scheme in this coming regulatory period.

Energy Efficiency

33. S54Q provides a mandatory requirement on the Commission to promote incentives, and avoid imposing disincentives, for suppliers of electricity lines services to invest in energy efficiency and demand side management. Despite this obligation, the Commission states that as the DPP will be a relatively simple mechanism the customised price path (CPP) may provide a more effective tool to provide incentives for energy efficiency.

34. Several submissions on the December discussion paper, including Vector's submission, discussed the financial disincentives under price-quality regulation for EDBs to invest in energy efficiency and demand side management measures. The points made in these submissions do not seem to have been incorporated into the Commission's analysis. There is also a substantial body of economics literature which supports the argument that price-quality regulation provides disincentives for investments in energy efficiency as reductions in energy usage cannot be recouped through price increases by EDBs. This disincentive is most pronounced under the DPP, where no allowance is made for quantity reductions.

35. In support of this argument, in its submission on the December discussion paper, CRA state: "EDBs currently face a financial disincentive to promoting measures that would reduce energy consumption. Under the current specification of the price path threshold the EDB faces the financial consequences of any change in demand, whether that is positive or negative. To remove this disincentive it would be necessary to add another factor to the price path specification that allowed the recovery of revenue that would otherwise be lost through energy efficiency measures." The Energy Efficiency and Conservation Association (ECCA) discussed in their submission a number of ways in which the economic regulation of lines companies can act as a disincentive to invest in energy efficiency measures. In particular, price-quality regulation can reduce EDBs ability to increase prices to recoup lost revenues which result from investment in demand side management and price-quality regulation can bias investment towards network augmentation rather than demand side management. We endorse the comment made by ECCA that "demand side management is an issue relevant to all lines companies and as such should preferable be included in the default price-quality path".⁴

⁴ See page 4 of the ECCA submission.

36. As discussed in our submission on the December discussion paper, in Australia the argument that there are disincentives to invest in demand side management appears to have been accepted by rule makers as the National Electricity Rules allow the Australian Energy Regulator (AER) to develop demand side management schemes. One such scheme is the D-factor which operates in New South Wales. Under the D-factor, distributors are allowed to increase their prices to recover any loss of revenue arising from lower energy sales as a result of demand side measures. Consumers are no worse off as the price increase is generally less than the savings from lower energy use and the investment reduces the costs of network investment in the long term. Reviews of the D-factor suggest that it has resulted in a modest level of increased investment in demand side measures such as power factor correction, on-site generation equipment and peak management initiatives.⁵ In the price control determinations for ERGON, ENERGEX and ETSA the AER implemented a demand management innovation allowance. Under Part A of the scheme an *ex-ante* allowance is set that can be recovered in revenue over the year. The allowance can be claimed for projects which reduce network demand. Under Part B of the scheme businesses can claim a payment for revenues lost as a result of demand management projects, similar to the D-factor. These claims are assessed on a case-by-case basis.

37. The Commission argue that demand management incentive schemes would be difficult to implement under the default price path as there is no mechanism to assess projects. We believe that a relatively simple scheme could be developed that allows an increment to prices to compensate distributors for volume reductions as a consequence of actions they take to reduce demand through energy efficiency initiatives. The Commission could either pre-define qualifying projects or use the asset management plans as a basis to assess proposals. For example, a distributor that actively installs solar hot water heating in their customer's premises could receive a fixed kWh per annum allowance for each installation.

38. Vector supports the view expressed by the ENA in their submission, that the Commission should treat the S54Q requirement as a mandatory consideration when making decisions under Part 4 with respect to electricity lines services, including decisions on the DPP. Vector considers that the Commission should undertake a through assessment of how the regulatory regime impacts on

⁵ See for example page 30: Institute for Sustainable Futures, *Win-Win-Win Regulating Electricity Distribution Networks for Reliability Consumers and the Environment* (Jan 2008) available at <http://www.tec.org.au>

incentives to promote energy efficiency and demand side management and should review mechanisms used overseas, particularly in Australia. Such a review would be consistent with the requirements of the new purpose statement, particularly S52A(a): incentives for investment and innovation.

Closing comment

39. Vector is happy to discuss this submission in more detail if that would be helpful. If you have any queries please contact Nathan.strong@vector.co.nz, 04 803 9039, in the first instance.

Kind regards

A handwritten signature in black ink, appearing to read 'Nathan Strong', is positioned above the printed name and title.

Nathan Strong
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