



**Initial Reset of the  
Default Price-Quality Path  
for Electricity Distribution Businesses**

**Draft Decision Paper**

**12 October 2009**

## Introduction

1. Powerco welcomes the opportunity to comment on the *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses: Draft Decision Paper* (“Draft Decision Paper”), published by the Commerce Commission (“the Commission”) on 8 September 2009.
2. We appreciate the constructive approach of the Commission in developing the default price-quality path (“DPP”) and look forward to further engagement to finalise the remaining DPP mechanisms.
3. We note that at least five issues relevant to the DPP are still to be consulted on (for example, starting price adjustments, claw-back, energy efficiency, the S-factor mechanism and enforcement guidelines). In addition, the input methodologies and many aspects of the inter-relationship between the DPP and customised price path proposals (“CPP”) are still to be determined. Due to these constraints the Draft Decision Paper has a narrow focus, and correspondingly, this submission is limited to that scope. As a number of interlinking decisions are unresolved, Powerco reserves the right to provide further comment or change our position when the remaining parts of the DPP regime are finalised.
4. As Powerco supports a number of the draft decisions, we have provided a table summarising our position in Annex A. More detailed comment on the areas where we continue to have concern is provided in the next section. This includes the:
  - continued use of the Economic Insight’s total factor productivity methodology;
  - the definition of price under allowable notional revenue;
  - definition of quantity under notional revenue; and
  - proposal to derive separate quality datasets on non-contiguous networks.
5. Powerco has seen a copy of the Electricity Networks Association’s (“ENA”) submission and supports its recommendations.
6. If you wish to discuss any aspects of this submission please contact:

Paul Goodeve  
Regulatory and Business Manager  
Powerco  
06 759 6216  
[Paul.Goodeve@Powerco.co.nz](mailto:Paul.Goodeve@Powerco.co.nz)

## Framework

### The Commission's interpretation of Part 4 Purpose Statement

7. The interpretation of the section 52A regulatory purpose statement is a vital part of the DPP reset process. In the June 2009 DPP Discussion Paper ("the June Discussion Paper") the Commission referred at several stages of the need to balance the regulatory objectives in section 52A(1)(a)-(d). In the Draft Decision paper, the Commission continues to state that it "may need to exercise its regulatory discretion and determine the appropriate weight afforded to each of these regulatory objectives".<sup>1</sup>
8. We believe there is now a common understanding of the interpretation of the regulatory purpose statement following the discussion at the Input Methodologies Conference on 17 September 2009. Andy Nicholls, on behalf of Powerco stated that,

So I think that the common ground I hope is that the section sets a clear standard for the Commission against which it can measure its decisions and the advice and submission that it's receiving, which is would this produce a regulatory outcome which you would expect to see in a workably competitive market. And then, in my view, the "such that" and the four other factors is consequential.<sup>2</sup>
9. Meaning that, when re-setting the DPP, the Commission's primary question should be whether its decisions are consistent with the outcomes produced in workably competitive markets.
10. In addition, Powerco agrees with the Commission's statement that dynamic efficiency is "arguably the most important form of efficiency in practice".<sup>3</sup> This should be taken into account when the objectives (a) – (d) are considered.

### Re-openers

11. The Commission's draft decision is not to create an interim provision for re-openers before the input methodology determination on this matter. If a six month extension is granted for the input methodology timeline, this increases the risk that:
  - a) an industry wide event may occur before the input methodology determinations; and
  - b) a firm may have circumstances requiring it to breach of the DPP price/quality path, but it will be unable to apply for a CPP.

---

<sup>1</sup> Commerce Commission, *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses: Draft Decision Paper*, 8 September 2009, page 10.

<sup>2</sup> Commerce Commission, *Input Methodology Transcripts, Electricity Distribution Businesses*, page 274.

<sup>3</sup> *Supra* n 2, page 16.

12. Powerco recommends that the Commission recognise the uncertainty that this may create and considers how best to address it (for example, the Enforcement Guidelines may be one option).
13. The Input Methodology Conference discussed the potential mechanisms to avoid an expensive customised price-quality path process being the only option to address firm specific issues. The instruments mentioned included a “short-form” CPP process, re-openers in the DPP and the DPP enforcement guidelines.<sup>4</sup> This is a complex debate and the form of a re-opener for the DPP should be established by the relevant input methodology.

## Price path

### Starting prices

14. The definition of price in the allowable notional revenue formula is “the price of service *i* at the assessment date occurring in calendar year *t-1*”. Consequently, the price path assessment formula recalculates allowable notional revenue each year based on the previous year’s prices.
15. If last year’s prices under-recovered the allowable notional revenue, then the EDBs is unable to recover this and the difference is compounded over the remainder of the regulatory period.
16. This penalises EDBs if they actively choose to under-recover revenue in one year for any reason. For example, to provide price stability to consumers or avoid a price shock in a high inflation year.
17. Powerco recommends that the price path assessment formula is adjusted to allow any under-recovered revenue to be carried forward (where the headroom is the difference between notional revenue and allowable notional revenue).

### Definition of quantity under notional revenue

18. Powerco agrees that annual base quantities should be updated each year, although we disagree with the reference period the Commission has proposed. The Commission outlines two options for selecting the reference period:
  - a period two calendar years prior to the assessment date (“t-2” approach); and
  - a period one calendar year prior to the assessment date (“t-1” approach).
19. We also notes that in the Commerce Act (Powerco Natural Gas Services) Authorisation 2008 (“the Gas Authorisation”), the Commission’s final decision on the definition of quantity was:

---

<sup>4</sup> Supra n 2, pp. 285-289.

For prices in year t, the quantities in the weighted average price cap be set as the audited relevant quantity for each component of price for the controlled services for the year ended 30 September for the year t-1. For example, for a price change on 1 October 2009, the businesses should use the quantities supplied for the year ended 30 September 2008.<sup>5</sup>

20. This is a t-2 approach as the reference period for base quantities is two years prior to the assessment date. Powerco supports a t-2 approach due to the implementation problems of a t-1 approach. Under a t-1 approach, although two thirds of the year will have passed in December, the quantity information available at that time still contains estimates. Powerco obtains its volume information from retailers and this is continually updated and reconciled using wash-ups. There can be significant movements in the data, particularly at year end. The increased accuracy of using more up to date data may be outweighed by the decreased accuracy of estimated information.
21. The Draft Decision proposes that under the t-1 approach, the Commission monitor the accuracy of the estimated volume information by requiring an additional compliance step when annual compliance assessments are submitted. This is a further compliance cost that Powerco considers unnecessary, as the t-2 approach is a suitable alternative.
22. The Commission recognises the problem of wash-ups in the Gas Authorisation Decision Paper when it states,

The quantities billed for a particular month will vary over a period of time as successive wash-ups of invoices take into account updated information. For the purposes of determining quantity weights, the Commission considers it appropriate to use, for the quantities for any year ending 30 September, the amount as washed up in the charges in invoices issued by Powerco up to the invoice being issued on or near the following 1 January and payable by the 20<sup>th</sup> day of that month.<sup>6</sup>
23. Our analysis also indicates that there will be minor differences in quantities between a t-1 approach and a t-2 approach, mainly because the quantity appears on both sides of the equation.

### **Pass through costs**

24. Powerco supports the inclusion of local authority rates, Commerce Act levies, Electricity Commission levies and transmission charges as pass through costs. Powerco agrees that pass through costs listed in the DPP may need to be reconsidered once the input methodologies are finalised. We also acknowledge that the Commission needs to establish a definition of pass through cost as part of the DPP determination, although this should not influence the final input methodology determination relating to this matter.

---

<sup>5</sup> Commerce Commission, *Gas Authorisation Decisions Paper*, 30 October 2008, page 287.

<sup>6</sup> *Ibid.*, page 286.

25. We note that the Gas Authorisation allows Powerco to apply for new pass through cost categories each year. Clause 6.4.3 of the Gas Authorisation states that,
- 6.4.3. Powerco may apply to the Commission by 1 February in any year to add a category of costs (for example, taxes where there has been a material change in tax law or in interpretation of tax law) as pass-through costs under *clause 6.4.1(g)* for the purpose of setting prices from 1 October of that calendar year.<sup>7</sup>
26. This timeframe requires Powerco to make an application eight months before the annual price change (which may include the new pass through cost category). If the same process is applied to the DPP, applications would need to be made by 1 August each year.
27. If a six month extension is granted for the Input Methodology determinations, the pass through cost determination will not be known until the end of December 2010, with the DPP determination altered in 2010. If allowed by the input methodology, the first opportunity to apply for new pass through costs would be 1 August 2011, applying to price changes on 1 April 2012. It is feasible that appropriate new pass through cost categories immerge before this. For example, the Electricity Commission may introduce new regulations on metering or unity power factor requirements.
28. We recommend that the DPP allows EDBs to apply for new pass through cost categories each year until the pass through cost input methodology is finalised.
29. On a technical issue, Powerco notes that the Commission considers that avoided transmission costs should be included as pass through costs. We support this and believe that the Commission should explicitly refer to this in the definition of transmission costs.

## Rates of change

### Concerns with the Economic Insights total factor productivity (“TFP”) methodology

30. Powerco supports an X factor of 0% per annum. We recognise that the Commission has considered a variety of matters in determining the X factor and an X of 0 is inline with the Pacific Economics Group (“PEG”) range.
31. Powerco continues to oppose the total factor productivity methodology developed by Economic Insights (“EI”). A number of the concerns raised by PwC Australia

---

<sup>7</sup> Commerce Commission, *Commerce Act (Powerco Natural Gas Services) Authorisation 2008*, 30 October 2008.

have not been adequately addressed.<sup>8</sup> Of particular concern is that the methodology is controversial and experimental. While the Commission may consider that EI's methodology and PEG's methodology have produced similar ranges, when applied over a longer time period or to the gas pipeline sector the results may diverge.

32. Powerco does not oppose the Commission reviewing new ideas on the total factor productivity methodology. We oppose the lack of robust debate on the EI methodology due to the limited time constraints of the DPP reset process. Using the EI methodology at this stage is inconsistent with the implementation principles of transparency and certainty. For example, transparency requires decisions with sound analytical foundations inline with decision of other regulatory jurisdictions. The EI methodology is clearly controversial and is not appropriate to use at this stage.
33. Powerco recommends that:
  - a) the Commission implements an X of 0, but recognises that more debate is required on the TFP methodology; and
  - b) the Commission holds a workshop on the TFP methodology in 2010 to enable a robust debate on the various methodologies before the X factor for the gas business is decided.
34. We also note that ENA has commissioned PEG to review the EI work in response to the Draft Decision Paper, and we agree with the contents of the PEG paper.

## Quality standards

### Accounting for extreme and normal variation

35. The Commission has outlined its draft decisions for normalising extreme and normal variation of quality performance. Powerco notes that ENA has commissioned SLA to consider the decisions below in more detail:
  - a) the manner in which non event days are treated;
  - b) the assumptions of log normal distributions for major event days ("MEDs");
  - c) replacing MED values with boundary values; and
  - d) the approach to multi-year assessment.
36. Powerco supports SLA's recommendations and also notes the following issues of concern. Powerco does not support the proposal that SAIFI MEDs are defined with reference to the SAIDI dataset. The Commission has two quality measures,

---

<sup>8</sup> PwC Australia, *Letter to Paul Goodeve at Powerco: Comments on the Reports of Economics Insights about the use of TFP in price caps*, 3 August 2009.

and therefore there should be two independent processes to determine the final quality measures. We recommend that an additional step in Appendix C is included to identify MEDs for SAIFI using the SAIFI boundary value.

37. There is a similar issue in the Commission's proposed "two out of three" approach to multi-year assessment. The Commission's description of the approach combines the SAIDI and SAIFI Reliability Targets. For example, an EDB would breach the quality threshold if the second instance of exceeding the Reliability Target was in SAIFI, although there may be no breach in SAIFI. Powerco recommends that SAIDI and SAIFI values are treated independently in this step.

### **Separate disclosure of non-contiguous networks**

38. In paragraph 7.22 in the Draft Decision the Commission states that EDBs with non-contiguous networks are to derive separate quality datasets for each non-contiguous network. The paper does not state if this is additional information to be included in the annual compliance report, or if there will be separate quality paths for each non-contiguous network.
39. Powerco does not support either of these options. Requiring separate quality paths increases the risk of a quality breach as not all normal variability can be accounted for in the design of the quality component. Separating the quality path does also not align with having one price path for the DPP. The DPP reflects the relationship between price and quality, and it is incoherent to have two quality paths and one price path.
40. The Commission can not raise this type of requirement at the draft decision stage of consultation. There needs to be a fuller discussion to allow the Commission and EDBs to assess the impact of this requirement on breaching quality.
41. Powerco already provides extensive information on the reliability of its Eastern and Western Network in comparison to its overall reliability performance.<sup>9</sup> This meets the Commission's need to assess if one networks quality is deteriorating significantly in comparison to another.
42. In addition, Powerco has always considered "geographical contiguity" to be an arbitrary method of categorising parts of an EDB network. In paragraph 102 the Commission states that "examples of EDBs with networks that are sufficiently distinct to be considered non-contiguous are Aurora and Powerco". To our knowledge no analysis of the "distinction" between our Eastern and Western Network has been undertaken by the Commission. Instead, the Commission has decided that geographical separation equates to topographical and climatic differences with no evidence base.

---

<sup>9</sup> See Powerco, *Information disclosure prepared according to subpart 9 of Part 4 Commerce Act 1986 – For the assessment period 1 April 2008 – 31 March 2009*, 31 August 2009.

## Excluded services

43. In the June Discussion Paper the Commission stated that it considered an excluded service to be “any electricity lines services if there is workable or effective competition for the provision of those services”.<sup>10</sup> The Commission has not included any discussion on the definition of excluded services in the Draft Decision Paper.
44. Powerco supports the definition in the Discussion Paper, although this definition would not capture a service awarded by a competitive bidding process. For example, a large customer could tender for a long term contract to build and supply its electricity lines services. In this case, it is not necessary for economic regulation to apply to these lines while the contract is in place.
45. Powerco recommends that the definition of excluded services is widened to include services where there is a written agreement between suppliers and purchasers, where they can agree to remove services from the terms set out in the DPP.

## The scope and timing of future work

### *Input methodology timeline and starting price adjustments*

46. Powerco notes that the Commission may be granted a six month extension, by the Minister of Commerce, to determining the input methodologies. This will have implications for the timing of starting price adjustments under the DPP. It would be helpful if an updated timeline for the starting price adjustment is published as soon as practical.
47. Determining the methodology for starting price adjustments and claw-back will have a substantial impact on investor certainty and be a major factor in a firm’s decision to apply for a CPP. Powerco reiterates its previous comments that the Commission must take a cautious and robust approach to this methodology.
48. In paragraph 1.8 of the Draft Decision, the Commission lists a number of areas for further work. Powerco agrees with this list and recommends that the issue of transitioning from the CPP to DPP (or transitioning from the DPP to CPP) is also included. There was discussion at the Input Methodologies Conference in September about how efficiency gains could be carried from one regulatory instrument to the other, and this process may have implications for the DPP determination.

---

<sup>10</sup> Commerce Commission, *Reset of Default Price-Quality Path of Electricity Distribution Businesses, Discussion Paper*, 19 June 2009.

### *Enforcement guidelines*

49. In the Draft Decision the Commission states that it expects to consult with interested parties in 2010 regarding the development of the Enforcement Guidelines.<sup>11</sup> Powerco recommends that Enforcement Guidelines are finalised in early 2010. It would also be helpful if the Commission published a discussion document before the end of December 2009 to give some indication of the content of the Guidelines as EDBs set prices for 1 April 2010.
50. A breach of the price or quality path is an illegal act and the Commerce Act 1986 allows significant penalties to be imposed. Powerco's comments on pass through costs illustrate that technical breaches are still possible, and businesses need certainty about how different types of breaches will be treated.

### *Consultation timeline on Draft Initial Reset Determination*

51. The Commission proposes to publish a Draft Initial Reset Determination ("Draft Determination") in mid-November 2009. As the DPP is a new regime, Powerco requires as long as possible to analyse the draft determination. We note that the Commission has allowed two weeks for cross submissions. Powerco would be comfortable with a one week cross submission consultation period if this allowed a longer time to analyse the Draft Determination.

---

<sup>11</sup> *Supra* n 1, page 3.

## Annex A

### Summary of Powerco's Response to Draft Decisions

Topic	Powerco's response
<b>Framework</b>	
Commission's interpretation of Part 4 purpose (p8)	The Input Methodologies conference established a general consensus between the Commission and EDBs on the interpretation of the purpose statement: that the regulatory objectives in s52A 1)(a)-(d) should be balanced inline with the workable competition standard.
Definition of consumer (p9)	Powerco supports the Commission's definition of consumer.
Regulatory framework principles (p11)	Powerco supports the Commission's economic and implementation principles.
<b>Considerations for the reset DPP</b>	
Energy efficiency (p23)	Powerco supports a cautious approach and the Commission's decision to develop an energy efficiency mechanism after the publication of the final DPP Determination.  Powerco supports the intention to allow EDBs flexibility in their tariff structures, within the Allowable Notional Revenue constraint, to provide incentives for energy efficiency initiatives.
Input methodologies (p29)	Powerco supports the Commission amending the Initial Reset Determination following the publication of input methodologies.
Re-openers (p30)	If the input methodology timeline shifts outwards, this will delay applications for CPPs and increase the risk a re-opener being required. Powerco recommends the Commission consider how to address this.
Structure of the reset DPP (p32)	Powerco supports the Commission's decision to: <ul style="list-style-type: none"> <li>• include separately assessed price and quality paths;</li> <li>• not include the customer communication criterion as part of the Reset DPP; and</li> <li>• work with interested parties to further develop a robust S-factor mechanism after 1 April 2010.</li> </ul>
<b>Price Path</b>	
Use of CPI-X (p37)	Powerco supports the Commission's decision to index the price path using a CPI-X mechanism.
Use of weighted average price cap (p38)	Powerco supports the Commission's decision to use a weighted average price cap.

Definition of price under national formula (p41)	Powerco supports the Commission's decision that a definition of price is based on that set out in the Thresholds Notice. Powerco recommends that the price path assessment formula is adjusted to allow any headroom in revenue to be carried forward.
Definition of quantity under notional revenue (p43)	Powerco recommends a t-2 approach is used as this is consistent with the Gas Authorisation and is easier to implement.
Pass through costs (p48)	Powerco supports the inclusion of local authority rates, Commerce Act levies, Electricity Commission levies and transmission costs as pass through costs. We support the Commerce levies for 2009/10 being recovered across regulatory period and no unbundling of transmission charges. Powerco recommends that the DPP allows EDBs to apply for new pass through cost categories each year until the pass through cost input methodology is finalised. We envisage a similar process to the one described in the Gas Authorisation.
<b>Starting prices</b>	
Timing of starting price adjustments during the reset DPP (p57)	Powerco supports an adjustment to starting prices taking place after the input methodologies are finalised. Powerco notes that the Commission may be granted a six month extension from the Minister. Powerco supports an extended timeline to allow robust consultation with interested parties.
Specification of starting prices for the reset DPP (p62)	Powerco supports the use of actual prices rather than the threshold formula prices.
<b>Rate of change</b>	
Context and productivity analysis	Powerco agrees that the X factor can not rely only on one total factor productivity methodology, but a range of factors and inputs must be taken into consideration.
Approach to TFP analysis	Powerco continues to oppose the total factor productivity methodology developed by Economic Insights. Powerco recommends that the Commission does not move forward with the Economic Insights report as a source of evidence until the methodology is further tested and debated. Powerco supports the analysis undertaken by the Pacific Economics Group on behalf of ENA.
Industry TFP growth rate	Powerco supports the use of financial measures, as advised by PwC in Powerco's submission to the Commission on 3 August 2009.
Analysis of productivity	Powerco supports an X factor of 0% per annum.
<b>Quality standards</b>	
Overall approach to setting	Powerco supports the "no material deterioration" approach

quality standards (p100)	proposed by the Commission.
Definition of quality (p101)	Powerco agrees that supply reliability should provide the basis for determining EDB service quality.
Non-contiguous networks (p102)	Powerco does not support the proposal to require EDBs with non-contiguous networks are to derive separate quality datasets for each non-contiguous network. The Commission can not raise this type of requirement at the draft decision stage of consultation, especially when the requirement in the draft decision is unclear. Powerco already provides extensive information on the reliability of its Eastern and Western Network in comparison to its overall reliability performance, and does not consider that further regulatory mechanisms are required.
Reference data (p103)	Powerco supports the use of daily SAIDI and SAIFI data from the period 1 April 2004 to 31 March 2009 to inform quality standards.
Accounting for extreme variation (p104)	<p>Powerco notes that ENA has commissioned SLA to consider the decisions below in more detail:</p> <ul style="list-style-type: none"> <li>a) the manner in which non event days are treated;</li> <li>b) the assumptions of log normal distributions for major event days (MEDs);</li> <li>c) replacing MED values with boundary values; and</li> <li>d) the approach to multi-year assessment.</li> </ul> <p>Powerco supports SLA's recommendations.</p>
Accounting for normal variability (p111)	Powerco supports the Commission's approach to use dead-bands, with the size of the dead-band based on the standard deviation present in the normalised dataset.
<b>Form of determination</b>	
Form of determination (p120)	Powerco supports the publication of a single determination.
Regulatory period (p120)	Powerco supports a five year regulatory period from 1 April 2010 to 31 March 2015.
Annual compliance date (p126)	Powerco supports an annual compliance submission deadline of 50 working days after each assessment date in the regulatory period.
Annual CPP proposal date (p127)	Powerco supports delaying publication of the annual CPP compliance date until after the input methodologies are published.