



# **Aurora Energy Limited**

**Submission to the Commerce Commission**

**on its**

**Draft Decisions Paper**

**on the**

**Initial Reset of Default Price-Quality Path**

**for**

**Electricity Distribution Businesses**

12 October 2009

## Introduction and Background

The Commerce Amendment Act 2008 provided for the transition of an Electricity Distribution Business' (EDB) price and quality paths under the former threshold regime (now repealed) to the 'Initial' Default Price-quality Path (DPP) under the new regulatory control provisions of Part 4 of the Commerce Act 1986.

As a transitional measure, the Initial DPP has application from 1 April 2009 to 31 March 2010. The DPP is required to be reset on 1 April 2010 (*2010 Reset*). To meet this statutory deadline, the Commission must determine, by 1 December 2009, the revised price and quality parameters that are to apply for the next regulatory period (from 1 April 2010 to 31 March 2015).

The Commission has commenced consultation on the DPP, and has recently published its *Draft Decisions*<sup>1</sup>. The Commission has requested submissions on its *Draft Decisions*.

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<sup>1</sup> Commerce Commission; "Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses - Draft Decisions Paper"; 8 September 2009

## Aurora's Submission on the Commission's Draft Decisions

Aurora welcomes the Commission's *Draft Decisions* for the 2010 Reset, and its acknowledgement that a future work-plan is required to address several issues that, due to restricted timeframes and/or without finalised input methodologies, will remain outstanding beyond 1 April 2010. These issues include:

- starting price adjustments and claw-back;
- integrating energy efficiency mechanisms;
- integrating price and quality (i.e. the S-factor); and
- enforcement guidelines.

Aurora accepts that it is appropriate to consult further on these issues and, where appropriate, to address these issues in an amended determination. Aurora considers enforcement guidelines and the price/quality integration to be the issues of greatest priority. For instance, Aurora is concerned that the enforcement guidelines will not be known at the time the regulatory control starts. In addition, Aurora continues to urge the Commission to advance the development of an integrated price and quality framework.

Aurora's submission on the *Draft Decisions* is relatively brief. In the main this reflects Aurora's broad agreement with the draft decisions that the Commission has formulated. The remainder of this submission sets out:

- key areas of the Commission's *Draft Decisions* that Aurora supports (and therefore sees no need for the Commission to revisit); and
- areas of concern that Aurora has with the *Draft Decisions*.

### 1.1 Support for the Draft Decisions

Aurora supports the *Draft Decisions* in the following areas:

- (1) Consistency with the legislative provisions relating to the DPP
  - The Commission appears to have taken a fairly pragmatic approach which Aurora considers to be consistent with the legislative intent for a low-cost reset of the DPP<sup>2</sup>.
- (2) Flexible pricing methodologies
  - Aurora agrees that the DPP does not lend itself to a specified pricing methodology (or the specification of maximum prices at a disaggregated level).
  - The weighted average price cap (i.e. notional revenue approach) is a widely accepted regulatory control method. It inherently allows tariffs to be adjusted to achieve commercial objectives without changing the overall notional revenue.
  - Flexibility in pricing methodologies may help certain energy efficiency initiatives to be achieved. Aurora notes the Commission's comments in relation to a revenue path as an alternative to a price path<sup>3</sup>. Whilst Aurora does not favour the revenue path alternative at this point in time, it recognises that a revenue path may help address volumetric risks that are inherent in energy efficiency initiatives. A revenue path warrants further consideration in conjunction with the Commission's proposed work-plan for integrating energy efficiency mechanisms.

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<sup>2</sup> In particular, the Commission's *Draft Decisions* reflect the Cost-effectiveness Principle.

<sup>3</sup> *Supra*, note 1, para 4.16

- (3) Starting prices
  - Aurora supports the Commission’s two step process to identifying starting prices. In particular, Aurora supports the deferral of potential starting price adjustments until after the determination of input methodologies.
  - The use of actual prices (as posted by each EDB as at 31 March 2010) as the starting prices under the DPP is supported by Aurora as it is a pragmatic way to commence the new regulatory regime.
- (4) Rates of change
  - Subject to the concern listed below, Aurora supports the Commission’s proposed X-factor.
- (5) Quality
  - Subject to the concern listed below, Aurora supports the Commission’s use of SAIDI and SAIFI reliability measures as reflecting quality within the control of EDBs.
  - Aurora supports the standard of ‘no material deterioration’ in quality, and in particular, the use of dead-bands and multiyear assessments<sup>4</sup>.

The Commission has indicated that it intends to refine and reconsider the issues addressed in its *Draft Decisions*, in light of submissions received<sup>5</sup>. However, in light of the above comments, Aurora does not envisage the Commission needing to make significant amendments to its *Draft Decisions*. The few specific areas of concern where Aurora would like to see changes are detailed below.

## 1.2 Aurora’s Concerns

Whilst the Commission’s *Draft Decisions*, as a package, are considered reasonable, Aurora has specific concerns in the following areas:

### (1) Delay of Input Methodologies

The Commission states that the deferred adjustment of starting prices should be completed in the five months following 30 June 2010 (i.e. the original date for Input Methodologies to be determined). This is consistent with: section 54K; alignment with the calculation period for the following EDB pricing year; and minimising the need for any claw-back adjustment<sup>6</sup>.

However, at the recent Input Methodologies Conference, the Commission raised the possibility that the Input Methodologies process may be delayed by (up to) six months. Aurora would be concerned if, as a result, this means that the likelihood of a claw-back is increased.

The Commerce Act 1986 includes a general presumption against retrospectivity, and the Commission has previously indicated that claw-back should only be implemented in exceptional circumstances:

*“... the Commission is initially of the view that claw-back should be well specified if it is to be used and only applied in exceptional circumstances, which would also need to be clearly set out in advance.”<sup>7</sup>*

<sup>4</sup> However, as explained later in this submission, Aurora has concerns with the suggested “2 out of 3” breach criteria for non-contiguous networks.

<sup>5</sup> *Supra*, note 1, para 1.5

<sup>6</sup> *Supra*, note 1, para 5.31

<sup>7</sup> Commerce Commission; “Reset of Default Price-Quality Path for Electricity Distribution Businesses: Discussion Paper”; 19 June 2009; para 289

Aurora endorses this perspective. However, notwithstanding this, the Commission considers a delay beyond 1 April 2011 in implementing the starting price adjustments to be a relevant consideration in determining whether to implement a claw-back:

*"A number of other relevant considerations are likely to guide the Commission's decision on whether or not to implement claw-back. These include:*

- *if for any reason the starting price adjustment does not take effect until after April 2011; and*
- *in the case of individual EDBs, whether the potential adjustment is sufficiently large."*<sup>8</sup>

In Aurora's view, implementing regulation for the first time will inherently involve some 'trial and error'. The Commission needs to take a cautious approach given the current economic environment, the limitations on forecasting and benchmarking profitability. In particular, the Commission must avoid claw-backs in all but the most extreme circumstances as, in the current environment; they create considerable regulatory uncertainty and undermine investor confidence. Aurora also reminds the Commission that it has borne the cost of regulatory 'trial and error' – for instance:

*"... Aurora believes that, in the context of the current regulatory learning curve, a philosophical approach to the clawback issue could be taken. For instance, Aurora notes that some of the current recommendations made by the Commission's advisors in relation to TFP analysis would probably have improved Aurora's past MTFP ranking if they were adopted by the Commission in 2004. Aurora had pointed out these issues at the time (e.g. normalisation for reliability and adverse operating conditions), but this was ignored. Aurora is not seeking any clawback in relation to this."*<sup>9</sup>

## (2) Excessive Profits versus Normal Returns

The Commission has indicated that downwards starting price adjustments may be required in the case of EDBs that are earning, or are likely to earn, excessive profits. On the other hand, upwards starting price adjustments may be required in the case of EDBs whose returns are below a normal rate of return. As noted above, the Commission may also have regard to 'profitability' in determining whether a claw-back should be effected.

*"A number of ... considerations are likely to guide the Commission's decision on whether or not to implement claw-back. These include ... whether the potential adjustment is sufficiently large."*<sup>10</sup>

Aurora is concerned with the use of terms such as 'excessive profits' and 'normal returns' in the context of workable competition. In workably competitive markets, superior firms tend to generate high profits – through superior decisions, innovation and efficiency. So long as these firms are not price gouging, then it is unlikely that their profitability performance will be deemed to be excessive.

Aurora has previously<sup>11</sup> urged the Commission to be cautious in determining starting price ( $P_0$ ) adjustments – due to the inherent difficulty in accurately assessing current and future profitability, and due to concerns with the potential application of financial capital maintenance. In Aurora's view it is critical that the Commission establishes:

- an opening Regulatory Asset Base (RAB) based on a 2010 ODV; and
- a robust approach to sharing (e.g. an efficiency carryover mechanism) to ensure both consumers and EDBs respectively benefit as they should from the underlying drivers of profitability performance.

Given the proposed two step process for starting price adjustments, Aurora considers that these issues are best addressed in the determination of the relevant input methodologies.

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<sup>8</sup> ibid

<sup>9</sup> Aurora Energy Limited; "Submission to the Commerce Commission on its Discussion Paper on the Reset of its Default Price Quality Path for Electricity Distribution Businesses"; 17 July 2009; p 33

<sup>10</sup> Supra, Note 7.

<sup>11</sup> For example, in Aurora's various submissions on Input Methodologies.

### (3) Pass-through of Regulatory Costs

Aurora fully supports the Commission's proposals to treat: local authority rates; Commerce Act levies; Electricity Commission levies; and transmission charges, as pass-through costs. However, Aurora continues to believe that regulatory compliance costs should be a pass-through cost as well. Aurora advances the following arguments for this position:

- regulatory compliance costs were not part of an EDB's cost structure as at 8 August 2001 when the current price path was effectively 'locked in';
- regulatory compliance costs tend to be an exogenous variable that EDBs have little control over;
- EDBs should not have to 'sell themselves short' on addressing regulatory risks; and
- treating regulatory compliance costs as a pass-through cost will place pressure on the Commission to ensure 'cost-effectiveness' in its regulatory processes.

Aurora is aware of the counter arguments - namely, EDBs can ratchet up the cost of regulatory compliance at the expense of consumers in the hope of an outcome that is good for them.

Whilst Aurora is of the view that regulatory compliance costs should constitute a pass-through cost, Aurora also notes that pass through costs are being considered as part of the Input Methodologies process. Again, Aurora suggests that these issues are best addressed in the determination of the relevant input methodologies.

### (4) Productivity (i.e. the X-factor for the Rate of Change)

As stated previously, Aurora supports the industry-wide X-factor determined by the Commission. An X=0 outcome is towards the upper end of a range that Aurora had determined using the more traditional B-factor approach<sup>12</sup>.

Aurora is, however, concerned that the Commission has not provided sufficient guidance on how it has determined the X-factor. If regulation is to be meaningful in influencing outcomes, then EDBs need to understand how parameters such as the X-factor are determined. Aurora appreciates that the legislation gives the Commission discretion over how it sets the X-factor, and that the Commission has used this discretion. For instance:

*"First, as noted above, there is a legislative requirement that the X-factor must be based on the long-run average productivity improvement rate achieved by the EDBs (or by suppliers in other comparable countries). This necessitates a focus on past performance. Secondly, even in the absence of such a requirement, it is difficult to forecast likely future productivity changes. Nonetheless, although the rate of change is to be based on past productivity improvement rates, the Commission notes that the incentives on EDBs created by the X-factor in the CPI-X price path are intended to be forward-looking, for the long-term benefit of consumers. Consequently, the Commission has not mechanistically derived the X-factor from any specific analysis of past productivity. Rather, the Commission's draft decision on the X-factor involves an exercise of regulatory discretion which has been informed by a number of productivity analyses of past EDB performance and the Part 4 Purpose."*<sup>13</sup>

In the previous Discussion Paper<sup>14</sup> the Commission presented a revised TFP approach that had been developed by its advisor, Economic Insights. In submissions on the Discussion Paper (and on two attendant reports prepared by Economic Insights), many EDBs (including Aurora) criticised the revised TFP approach. The Electricity Networks Association (ENA) commissioned Pacific Economics Group (PEG) to prepare a report into EDB productivity that could be used by the Commission in setting the X-factor.

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<sup>12</sup> The B-factor approach was used by the Commission to determine industry-wide productivity for electricity lines businesses under the (former) threshold regime.

<sup>13</sup> Supra, Note 1, para 6.4

<sup>14</sup> Supra, Note 7.

As set out in more detail in Aurora's previous submission<sup>15</sup> on the Commission's Discussion Paper, Aurora does not support the Commission's/Economic Insights' revised TFP approach on the grounds that it:

- is grounded in a regulatory paradigm inconsistent with workable competition, low-cost regulation, and an industry-wide productivity metric;
- departs from international practice on productivity based regulation; and
- increases complexity but not necessarily accuracy, and as a result undermines incentives for productivity improvement.

On the other hand, the alternative TFP approach advocated by ENA/PEG is arguably more relevant to the analysis of competitive sector productivity. However, the Commission's view is informed by both of these approaches, together with reference to the former B-factor approach:

*"Therefore, the Commission's view is that it is appropriate to consider the long-run average productivity improvement rates for EDBs suggested by the revised TFP approach. The Commission considers, however, that it is useful to also undertake a productivity analysis using the former B-factor approach as well. This will allow the impact of the refinements to be understood individually and in combination, and will provide a check on the results found from using the amended TFP X-factor approach. In addition, the Commission has received a report by PEG on EDB productivity, commissioned by ENA ... PEG uses the B-factor formula, but has adopted a different approach to defining the inputs and outputs to that used by Economic Insights. The Commission has taken PEG's report into account in making its draft decision on the X-factor."*<sup>16</sup>

Whilst accepting that it is valid for the Commission to avoid an overly mechanistic approach to the determination of the X-factor, Aurora also notes that it is within the spirit of the Commerce Amendment Act 2008 to reduce regulatory uncertainty. The Commission's approach to determining the X-factor warrants revision (although the X-factor is unlikely to change<sup>17</sup>) for the following reasons.

- Firstly, it is not an appropriate application of the Commission's discretion to base its decisions on two (or more) alternative measures because their outcome sets overlap. In the future, underlying variables may change so that there is no overlap. In such circumstances, EDBs will not know how the Commission may prioritise these measures in the future. EDBs will therefore have no certainty over what outcomes they may face in the future – either as a result of commercial/investment decisions, or as a result of economy-wide factors.
- Secondly, the choice of outcome range should be based on a productivity metric that is consistent with the regulatory purpose. Aurora considers that the Commission's/Economic Insights' revised TFP approach is flawed in this regard.
- Finally, the choice of outcome range should be based on a productivity metric that is internally consistent. The input price differential term constitutes the primary difference between the Commission's revised TFP approach and the B-factor formula<sup>18</sup>. However, Aurora notes that amortising sunk costs, as the Commission proposes, creates a potential bias against EDBs – as although sunk costs are not unique to EDBs, the Commission is not proposing that the input price term for the broader economy should also be adjusted to reflect sunk cost considerations (e.g. as it affects industries in the wider economy such as electricity generation and transmission, pipeline networks, telecommunication networks, roads, water supply systems, and railway lines).

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<sup>15</sup> Supra, Note 9.

<sup>16</sup> Supra, Note 1, para 6.59

<sup>17</sup> Aurora's proposals would, if anything, place downward pressure on the X-factor range that the Commission is to consider.

<sup>18</sup> Whether the B-factor formula applied in setting the price path under the former threshold regime, or the variant of the B-factor formula proposed by ENA/PEG.

Aurora strongly recommends that the Commission reject the Commission's/Economic Insights' revised TFP approach in favour of the traditional B-factor approach. This approach, being easier to understand, will be more likely to influence commercial/investment decisions, and will provide greater certainty for regulated businesses. It is also more consistent with the regulatory purpose and the DPP framework.

(5) Reliability for non contiguous networks

The *Draft Decisions* require both Powerco and Aurora to create a separate price-quality path for each of their non-contiguous network areas.<sup>19</sup>

Aurora considers that this proposal will impose on Aurora (and Powerco) a higher standard of compliance than other regulated EDBs (without necessarily imposing a higher reliability requirement). The mathematics of this is quite simple. For instance, consider the situation for an EDB that owns two networks:

- under a single Quality Path for the total network, better quality in one network area in a given year may offset poorer quality in the other network area in the same given year and there is no breach of the single Quality Path;
- however, with separate Quality Paths for each network area, this ability to offset performance attributes is not available and a breach of one of the two Quality Paths is more likely to occur.

In effect, both Powerco and Aurora would have increased (perhaps double) the risk that reliability in any year will breach the Quality Path. When the principles of consistency and fairness are considered then Aurora does not believe that separate Quality Paths are appropriate. This is of considerable concern to Aurora.

Aurora strongly urges the Commission not to adopt separate quality paths for non-contiguous networks. In this regard, Aurora believes that the appropriate place to publish reliability data for each non-contiguous area is in the annual disclosure as per the Information Disclosure Requirements 2008 (which is currently disclosed) and in addition Aurora reports on reliability trends for each of its non-contiguous network areas in its Asset Management Plan.

Aurora notes that the Commission does not appear to apply the separate Quality Path to those networks where the consumer controlled test applies for disclosure of reliability performance. Singling out Aurora and Powerco would appear to be inconsistent with the Information Disclosure Requirements.

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<sup>19</sup> Supra, Note 1, paras 7.20 to 7.22

## Conclusion

Aurora regards the Commission's *Draft Decisions* as representative of substantial progress towards a reset DPP on 1 December 2009. As has been intimated in this submission, Aurora does not envisage the Commission needing to change these *Draft Decisions* much at all. Aurora's few areas of concern have been identified in the preceding section of this submission.

The 2010 reset will not be complete until input methodologies have been finalised, and the following key issues have been resolved satisfactorily:

- starting price adjustments and claw-back;
- integrating energy efficiency mechanisms;
- integrating price and quality (i.e. the S-factor); and
- enforcement guidelines.

Aurora will continue to work with the Commission to advance the resolution of these issues and to finalise the input methodologies.