

27 October 2009

David Healy  
Chief Adviser  
Network Performance Branch  
Commerce Commission  
PO Box 2351  
WELLINGTON

By email to [NPB@comcom.govt.nz](mailto:NPB@comcom.govt.nz)

Dear David

**Cross Submission on the Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses – Draft Decisions Paper**

The Commerce Commission (Commission) has published a *Draft Decisions Paper*<sup>1</sup> setting out its preliminary views on the proposed content and form of the Default Price-quality Path (DPP) which is to take effect from 1 April 2010. Various parties, including the Auckland Energy Consumer Trust (AECT), made submissions on the *Draft Decisions Paper*. Following the publication of these submissions, the Commission has invited interested parties to make cross submissions.

This letter provides the AECT's cross submission, and it is relatively brief – given the broad consensus in the submissions on the *Draft Decisions Paper*.

The key areas that the AECT wishes to comment on in this cross submission are:

1. Key changes to the Commission's draft decisions

In addition to the recommendations made by the AECT in its submission<sup>2</sup>, the AECT supports the key changes proposed by Vector in its submission.<sup>3</sup> These included:

- Adopting a *t-2* approach to establishing quantities. This avoids the additional compliance uncertainty (i.e. reconciling quantity estimates with actual quantities) under the proposed *t-1* approach. As a practical

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

<sup>2</sup> AECT recommended no clawback following  $P_0$  adjustments, greater clarification of how the X-factor is to be set, incentive mechanisms, and the pass-through of regulatory costs (see AECT; "Submission to Commerce Commission on the 2010 Reset of the Default Price-Quality Path"; 12 October 2009)

<sup>3</sup> Vector Limited; "Submission to Commerce Commission on Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses: Draft Decisions Paper"; 9 October 2009

matter, AECT also notes that the impact on prices is likely to be insignificant as between the approaches, but the  $t-2$  approach is more consistent with the Gas Authorisation that applies to both Vector and Powerco.<sup>4</sup>

- Adopting the latest RBNZ CPI forecasts (as required) for setting the price path. This is in preference to the lagged CPI approach proposed by the Commission.
- Substituting extreme event values with average rather than boundary values in the assessment of EDB quality.
- Allowing a more comprehensive set of pass-through costs (including regulatory costs).

The treatment of regulatory costs as pass-through costs was addressed in the AECT's submission.<sup>5</sup> In this regard, AECT also supports Powerco's submission that EDBs be permitted to apply for new pass-through cost categories each year (i.e. consistent with the Gas Authorisation)<sup>6</sup>.

## 2. Determining the Rate of Change

AECT agrees with the need to have greater certainty around the determination of productivity – i.e. the X-factor. For instance:

*"Vector recommends that the Commission add productivity analysis to the list of topics to revisit"*<sup>7</sup>

*"Powerco recommends that ... the Commission holds a workshop on the TFP methodology in 2010 to enable a robust debate on the various methodologies ..."*<sup>8</sup>

AECT does not support the approach proposed by Economic Insights – the results of which have been given some weight by the Commission. In this regard, the AECT strongly supports the views of other submitters – as follows:

*"Vector continues to have reservations regarding the highly theoretical and complex nature of the Economic Insights approach."*<sup>9</sup>

*"Of particular concern is that the methodology is controversial and experimental. ... 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."*<sup>10</sup>

*"We continue to be concerned however, that the EI approach reflects a new and untested approach which differs from the traditional and former B-factor approach"*<sup>11</sup>

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<sup>4</sup> Powerco; "Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses: Draft Decisions Paper"; 12 October 2009; pp 4-5

<sup>5</sup> Supra, Note 2

<sup>6</sup> Supra, Note 4, p6

<sup>7</sup> Supra, Note 3, p9

<sup>8</sup> Supra, Note 4, p7

<sup>9</sup> Supra, Note 3, p9

<sup>10</sup> Supra, Note 4, p7

<sup>11</sup> PricewaterhouseCoopers; "Submission to the Commerce Commission on the Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses - Draft Decisions Paper – Made on behalf of 18 Electricity Distribution Businesses"; 12 October 2009; p10

AECT also supports the PEG's conclusions that:

*"...the sunk cost issues that occupy so much of EI's analysis are puzzles that exist only at the theoretical level and not on the more practical plane of TFP measurement*

*... EDBs and customer groups will literally never understand the rationale for how prices are adjusted under the rate of change formula."*<sup>12</sup>

There is considerable uncertainty concerning how the Commission may determine productivity in the future. AECT supports the traditional B-factor approach. As an aside, the AECT notes that both PEG and Economic Insights make mention of their approaches being consistent with financial capital maintenance (FCM)<sup>13</sup>. AECT contends that FCM has not yet been established as necessary. To promote certainty in the future, AECT has submitted that (ideally) productivity should be treated as an input methodology<sup>14</sup>. This approach would also allow the X-factor to be reset, pursuant to s54K(3) of the Commerce Act 1986 (the Act), once the appropriate method has been determined as an input methodology.

### 3. Setting X=0

AECT supports the Commission's proposal that X=0 as a pragmatic outcome. However, MEUG, in its submission<sup>15</sup>, believes that the X-factor should be higher. MEUG justifies this on the grounds that:

- the Commission's advisors (Economic Insights) own analysis (excluding Consumer Owned EDBs) leads to an X of 0.6; and
- under the prior Threshold Regime, the Commission found, on average, that X should be 1.

These justifications for a higher X-factor value are misleading.

First, the Economic Insights analysis is not necessarily the most reliable benchmark of productivity (as its 'disputed' treatment of sunk costs provides an upwards bias to the X-factor). In addition, it is clear that MEUG has been rather selective in arguing for X=0.6 on the basis of Economic Insight's analysis. For instance, the X-factor is the difference of two terms – a *productivity growth differential* and an *input price growth differential* – and MEUG has taken the worst combination of these terms as follows:

#### *i. In relation to the **productivity growth differential***

*"Based on the available information, a conservative course of action would be to set the productivity growth differential term in the X factor to zero based on the overall industry and market sector performance. If that part of the industry that is likely to be subject to the default price path is taken to be the relevant industry definition then the productivity growth differential would have a positive value of around 0.4 per cent."*<sup>16</sup> Note: MEUG has adopted 0.4

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<sup>12</sup> Pacific Economics Group; "Submission to Initial Reset of the Default Price Path for Electricity Distribution Businesses - Draft Decisions Paper"; October 2009; p30

<sup>13</sup> Idem (pp 7-8 for example)

<sup>14</sup> AECT; "Submission to Commerce Commission on Input Methodologies"; 14 August 2009; p22

<sup>15</sup> Major Electricity Users' Group; "Submission on draft decision for Initial Reset of Default Price-Quality Path for Electricity Distribution Businesses"; 12 October 2009

<sup>16</sup> Economic Insights; "Electricity Distribution Industry Productivity Analysis – 1996-2008"; Report prepared for Commerce Commission; 1 September 2009; p 40

ii. In relation to the **input price growth differential**

*"The available evidence indicates that, using the rigorous amortisation charge approach which takes account of ex ante FCM, the distribution industry as a whole has exhibited slightly slower input price growth than the economy as a whole over the last 13 years. This would point to a small input price growth differential of in the order of -0.2 to -0.3 per cent per annum. All else equal, this would tend to make the X factor marginally larger than it would be based solely on productivity considerations. A conservative course of action in favour of the EDBs would be to set the input price growth differential term in the X factor to zero given its relatively small magnitude over both the whole period and the more recent period."*<sup>17</sup> Note: MEUG has adopted -0.2

As a consequence of this 'selective' analysis the X-factor is 0.6 (i.e. the difference between these two terms is  $0.4 - (-0.2) = 0.6$ ). Economic Insights records this as follows:

*"If the industry coverage was limited to those EDBs that are likely to be subject to the default price path ... the resulting X factor would be higher at around 0.6 per cent."*<sup>18</sup>

However, in performing this selective analysis, MEUG ignores Economic Insights actual recommendations – which are as follows:

*"Since the X factor is the difference between the productivity growth differential and the input price growth differential and we have conservatively recommended that each of these be set to zero, it follows that the X factor would also be zero."*<sup>19</sup>

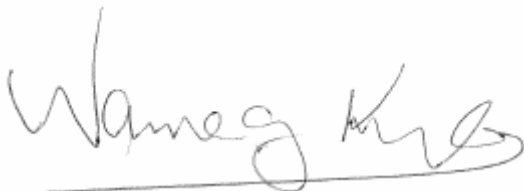
Second, MEUG suggests that the X-factor may be held at 1% (being the average under the Thresholds regime). AECT disagrees, noting that the X-factor under the Thresholds regime was an amalgam of the B-factor (industry productivity), a C<sub>1</sub>-factor (relative productivity) and a C<sub>2</sub>-factor (relative profitability). Pursuant to s53P(10) of the Act, the Commission is not permitted to undertake comparative benchmarking (i.e. the C<sub>1</sub>-factor, and arguably the C<sub>2</sub>-factor). If MEUG is referring simply to the B-factor being 1% *in the past*, then this ignores Economic Insights' findings that the B-factor would now be closer to -1%. For instance:

*"Using the output and capital cost methods adopted in Lawrence (2003) would lead to an X factor of around -1 per cent."*<sup>20</sup>

AECT appreciates the opportunity to make this cross-submission and looks forward to these matters being taken into account in the Commission's final determination.

Yours sincerely

Auckland Energy Consumer Trust



Warren Kyd  
Chairman

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<sup>17</sup> Idem, (p 41)

<sup>18</sup> Idem, (p 42)

<sup>19</sup> Ibid and Idem (p iv)

<sup>20</sup> Idem, (p42) – note the reference to Lawrence (2003) is a reference to the former B-factor analysis.