Submission to the Commerce Commission

on

Input methodologies review: Invitation to contribute to problem definition

Made on behalf of 20 Electricity Distribution Businesses

PwC submission on behalf of group of 20 EDBs

21 August 2015

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Submission on IM review problem definition paper

Overview

1. This paper forms our submission on the Commerce Commission's (Commission) Consultation Paper, "Input methodologies review, Invitation to contribute to problem definition" released on 16 June 2015 (the Consultation Paper). This submission has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 20 Electricity Distribution Businesses (EDBs or distributors):

    - Alpine Energy Limited
    - Aurora Energy Limited
    - Buller Electricity Limited
    - EA Networks
    - Eastland Network Limited
    - Electra Limited
    - Electricity Invercargill Limited
    - Horizon Energy Distribution Limited
    - MainPower New Zealand Limited
    - Marlborough Lines Limited
    - Nelson Electricity Limited
    - Network Tasman Limited
    - Network Waitaki Limited
    - Northpower Limited
    - OtagoNet Joint Venture
    - The Lines Company Limited
    - The Power Company Limited
    - Top Energy Limited
    - Waipa Networks Limited
    - Westpower Limited.

2. These businesses together supply 28% of electricity consumers, maintain 46% of total distribution network length and service 72% of the total network supply area in New Zealand. They include both consumer owned and non-consumer owned businesses, and urban and rural networks located in both the North and South Islands.

Input methodology review

3. The Commission is required by statute to review the input methodologies (IMs) at least every seven years. The Commission's intention is to complete the review by December 2016, one year early. The Commission released the Consultation Paper to identify the issues that have been raised so far in the review as potentially requiring changes to the IMs, and the Commission's preliminary view on those issues.

4. The Commission has also released for comment two draft decision-making frameworks that are intended to set out how and when decisions to amend the IMs will be made.

5. On 29-30 July the Commission held a forum where interested parties could present initial views on selected items relevant to the IM review. The EDBs which support this submission appreciated the opportunity to attend the forum and consider the issues raised by the forum participants.

6. The Commission has decided to fast-track certain issues relating to applications for customised price-quality paths (CPPs), so the IMs are updated in time to apply to any CPP applications that are made in early 2016. The fast-track issues include:

    - refining and simplifying the information requirements and processes for a CPP application (decision expected in November 2015); and
    - the alignment of the cost of capital that applies to default price-quality paths (DPPs) and CPPs (decision expected in February 2016).

7. This submission responds to the non-Airport topics raised in the Consultation Paper and considers the process and framework for the review. The EDBs which support this submission also support the submission made by the ENA. The purpose of this submission is to highlight topics of particular interest to the 20 EDBs listed on the previous page.

8. We trust this submission provides useful input to your consultation on the Consultation Paper. We would be happy to answer any questions you may have regarding this submission.

9. The primary contact for this submission is:

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Summary

10. The following points summarise our views on matters raised in the Consultation Paper, and are explained more fully in the body of this document.

Process for the IM review

11. The EDBs which support this submission agree that it is a useful first step to attempt to define up-front the problems to be addressed in the review.

12. We also consider that it is essential that there is more consultation and stakeholder interaction over the next few months to support the Commission to develop a robust draft decision. This should include setting out a clear set of options on each topic (including doing nothing), and consulting on them, before the draft decision stage.

13. We support the development of a decision making framework which sets out a set of principles for reviewing and modifying IMs. In particular we consider:

    - it is important to start with an assessment of how well the current IMs are meeting the statutory purpose;
    - when errors are identified they should be corrected as soon as possible and updated versions of the IMs should be provided;
    - other than for error correction, the Commission should strive to avoid making changes to the IMs between the 7-yearly statutory reviews; and
    - there is little advantage in excluding the option of introducing a new IM at some stage in the future.

Risk allocation

14. The Consultation Paper discusses a range of risk management tools that it claims are available to regulated suppliers. We suggest that the Consultation Paper may be over-stating the ability of EDBs to manage certain risks.

15. EDBs reasonably expect to be able to recover all of their prudent investment costs. The risk allocation this implies is reflected in the low regulatory cost of capital.

16. We endorse the ability to reopen DPP and CPP price paths for catastrophic events and change events or to address errors or misleading information.

17. As CPPs are prohibitively complex and costly, we consider that there would be significant value – to consumers and suppliers - in introducing a reopener to address particular aspects of a DPP where:

    - an assumption/approach adopted by the Commission is clearly inappropriate for an EDB for the DPP regulatory period; and
    - the impact of that assumption on the business meets the existing re-opener materiality thresholds.

18. We suggest that the Commission could provide more detail about how forecast and actual inflation are accounted for in the various regulatory mechanisms, and in particular how this is consistent with:

    - providing suppliers with compensation for prudently and efficiently incurred costs;
    - earning normal returns; and

- outcomes produced in competitive markets.

19. We have previously submitted that the option to apply for a CPP is currently not an option that is realistically available for many non-exempt EDBs. We include a number of suggestions in this respect in this submission, including extending the scope of DPP re-openers and single issue CPPs.

Form of control

20. We support a form of control that is simple and minimises compliance cost and forecasting risk.

21. We do not consider that there is a clear case for either a revenue cap or a price cap at this time, and therefore we encourage further investigation into this topic, before a draft decision is reached.

22. We are concerned by the comment in the Consultation Paper that changing the form of control could result in a change to the regulatory WACC. As discussed in the ENA submission on the Consultation Paper there does not seem to be a strong evidentiary basis for this view. If the Commission has evidence suggesting that the WACC could change as a result of changing the form of control, we request this is put on the table early for submitters to review. This would mean the debate about the form of control can focus on which form of control delivers the best outcomes.

DPP and CPP interactions

23. CPPs should only be necessary to address unusual circumstances such as a catastrophic event or a major change in expenditure requirements that could not have been foreseen and accommodated within a DPP (including a step-change in quality to better meet consumer preferences). The IMs should support this outcome, and not introduce other distortions.

24. Currently the cost of capital estimates that are used to determine DPPs and CPPs vary as they are determined at different times. We agree this is a valid issue to consider in the context of incentives for CPPs and DPPs and there are several options available to address it. In the body of this submission we consider the following options:

    - setting the CPP WACC equal to the DPP WACC;
    - updating some or all WACC parameters annually; and
    - using longer term averages for bond yields.

Emerging technologies

25. The EDBs which support this submission, agree that emerging technologies are relevant to the IM review. We note that the New Zealand context is important in this respect, and we should not rely solely on evidence from other jurisdictions in this respect.

26. We consider that the IMs may be able to be amended in ways which better accommodate increased uptake of emerging technologies and changing consumer demands. These may include refinements to the asset valuation IM (including depreciation, revaluation and disposal methods) and incentives for EDBs to invest in research and development in relation to emerging technologies.

27. We also encourage the Commission to support efforts to improve pricing flexibility to assist EDBs to commercially manage the transition to new technologies and deliver efficient pricing structures.

28. We note that one of the key challenges for the regulatory framework in considering the impact of emerging technology will be the future capex and opex allowances and quality standards for the purpose of price-quality regulation.

Cost of capital

29. In its IM merits appeal judgment of December 2013, the High Court raised concerns regarding several aspects of the cost of capital IM. In this respect we note:

- unless there is new material which has come to light since the WACC percentile review last year, we do not consider it should receive significant attention at this time;
- the simplified Brennan-Lally Capital Asset Pricing Model (SBL-CAPM) approach is widely used in New Zealand, and had significant support when it was adopted in the IMs in 2010;
- the basis for having a term credit spread differential allowance remains valid if the cost of debt method is retained; and
- a split cost of capital approach would damage investment incentives and we are not aware of it being applied by other regulators.

30. The WACCs that have been determined for price-quality and information disclosure purposes under the IMs have been more variable than we expected. This should be addressed and we set out some options in this regard in the body of our submission.

CPP rules and processes

31. We support the detailed submission made by the Electricity Networks Association in 2014 on improvements that can be made to the CPP IMs and the CPP submission and assessment processes.

32. We support changes to achieve these aims being made as part of the fast-track process. Introducing additional flexibility in how an applicant responds to the CPP IM should be a priority for the fast tracked changes. A more considered process (including allowing for sufficient inputs from stakeholders) is necessary to undertake the substantial redrafting which is required to the CPP IM.

33. It is important that the CPP is a cost-effective option for all non-exempt EDBs. In the body of this submission we set out proposed changes to the IMs which are consistent with this objective.

Complexity and compliance costs

34. The Consultation Paper suggests the IM review could find ways to reduce complexity in the IMs and the compliance costs they create. We strongly support this objective. The compliance burden created by Part 4 regulation on the small to mid-sized EDBs is excessive and reducing this should be a key focus of the IM review.

35. We encourage the Commission to include in the IM review process the outstanding actions which are necessary to correct and improve the Information Disclosure Determination (IDD), which applies to all EDBs.

36. The current design of the related party rules gives rise to unnecessary confusion and complexity. We consider that it is important to improve the consistency between the ID and IM requirements to help suppliers to apply the options and rules.

37. A key improvement to the related party rules would be to remove the linkage to the cost allocation IM term ‘directly attributable cost’ in order to:

- ensure that related party charges include recovery of both direct costs and shared costs;
- ensure related party arrangements are not penalised relative to in-house models or external provider models;
- ensure related party costs are valued consistently with arms’ length prices when the qualifying criteria are met; and
- be consistent with the NPV=0 economic principle which underpins the IMs.

38. The CPP IM related party rules also require revision because they are overly onerous, and impractical to apply to forecast periods.

39. Other topics for improvement include how transactions are treated in the asset valuation and regulatory tax IMs, seeking ways to better align the IMs with GAAP, making the asset valuation IM easier to apply and reviewing the IRIS IM to reduce unnecessary complexity.

40. Finally, we encourage the Commission to ensure the IMs are accurate, robust and error-free. The EDBs which support this submission would be happy to assist with this process.

Process for the IM review

Undertaking the review

41. The EDBs which support this submission have previously provided a number of comments regarding how the IM review is to be undertaken. These were outlined in our response to the IM open letter.[1] In that submission we responded to the proposed timing of the review, noting that the primary consideration was that sufficient time was made available for the review.

42. We also suggested that in undertaking the review, the Commission should:

    - address outstanding actions which are necessary to improve the IDD;
    - clarify the consultation process that will be followed during the IM review; and
    - consider learnings from the merits review process.

43. We re-iterate these points in this submission, as they are not explicitly acknowledged in the current consultation papers.

44. The EDBs which support this submission agree that it is a useful first step to attempt to define up-front the problems to be addressed in the review. We also found the IM review forum to be a helpful way of exposing the issues for debate and the perspectives of different stakeholders.

45. Following submissions on the Consultation Paper, the next scheduled step in the IM review process is a draft decision to be issued in the second quarter of 2016. We understand that the Commission intends to have some form of further consultation with stakeholders in advance of the draft decision, although there is no information included in the Consultation Paper about this.

46. The EDBs which support this submission consider it is essential that there is more consultation and stakeholder interaction over the next few months to support the Commission to develop a robust draft decision. We recommend that the Commission set up working groups made up of either stakeholder representatives or their experts (depending on the topic). These groups could examine particular topics in some detail, undertake research if necessary, identify solutions and clarify where there is agreement or disagreement. We would be happy to be involved in working groups and assist in developing solutions.

47. We also consider that it is necessary to set out a clear set of options on each topic (including doing nothing), and consult on them, before the draft decision stage. This needs to occur with sufficient time for stakeholders to meaningfully evaluate the options, and respond accordingly, and for the Commission to have sufficient time to consider this feedback prior to drafting the draft decisions.

Decision-making framework

48. We support the development of a decision making framework which sets out a set of principles for reviewing and modifying IMs. In our response to the IM letter in March, we suggested that the scope of the IM review should focus on:

    - new evidence or a change of circumstances which may signal that improvements to the IMs can be made to meet the purpose of Part 4, in a materially better way;

[1] PwC Submission on behalf of 20 EDBs, Response to the Commerce Commission on the IM Letter on the proposed scope, timing and focus for the review of the input methodologies, 31 March 2015

- changes which reduce compliance cost and complexity; and
- simple fixes to address errors, ambiguity or unintended consequences.

49. Therefore the EDBs which support this submission broadly agree with the Commission's aim to focus only on changing those aspects of the current IMs that would better promote the purpose of Part 4 or the Purpose of Input Methodologies (as set out in the Act), or reduce costs or complexity.

50. We do not understand the suggestion that new IMs cannot be introduced and question whether this is consistent with the intent of Part 4 of the Act, and importantly whether this was clearly understood by stakeholders when the IMs were first determined in 2010. In this respect we do not consider it is necessary to include this assumption in the decision making framework. We can see little advantage in excluding the option of introducing a new IM at some stage in the future.

51. We support the ENA submission and the supporting legal opinion from Russell McVeagh regarding the draft decision-making frameworks. We do not repeat that analysis here, but make three points of particular importance:

    - it is important to start with an assessment of how well the current IMs are meeting the statutory purpose. It is not clear this question has received much, if any, attention in this IM review so far;
    - errors within the IMs and other Part 4 determinations cause confusion and compliance costs. When errors are identified they should be corrected as soon as possible and updated versions of the IMs should be provided; and
    - other than for error correction, the Commission should strive to avoid making changes to the IMs between the 7-yearly statutory reviews. Revisiting IMs within the 7-year windows creates confusion and reduces certainty as EDBs need to review, understand and implement the changes that are being made in isolation of other parts of the IMs. We do not expect substantive policy changes to occur within the 7-year windows, including in advance of price resets. We remain concerned that the Commission has chosen to bring forward this IM review by 1 year. Retaining the 7-year timeframe would have improved certainty and reduced cost. The Commission's reasoning for concluding the review one year early relates to gas and airport price setting processes and is not relevant to EDBs.

Risk allocation

52. The Consultation Paper considers risk allocation mechanisms under price-quality paths. While this section is framed around price/quality paths, it is important to note that the principles embodied in the DPP and CPP IMs are replicated (to some extent) in the information disclosure (ID) IMs. Even where they are not in the IMs, they form a reference point for exempt EDBs when setting their annual revenue targets.

Scope for EDBs to manage risks commercially

53. The Consultation Paper discusses a range of risk management tools that it claims are available to regulated suppliers, including network resilience investments, hedging, contracting arrangements and maintaining option value by deferring large investment decisions. It does not identify particular problems as such, but does note that it is important to consider risk allocation and compensation in a holistic way.[2]

54. We suggest the Consultation Paper may be over-stating the ability of EDBs to manage certain risks. It is generally not possible to obtain insurance to cover the majority of EDBs' networks for physical damage. As a result business interruption insurance is also not available. Network strengthening can be prohibitively expensive, in particular for rural networks where only single feeder supplies can be justified in many areas. Similarly, alternative contracting arrangements tend to be largely unavailable in smaller and rural networks. We therefore remind the Commission that EDBs do bear commercial risk, and that under Part 4 regulation, the appropriate compensation for that risk is addressed through cost recovery, including through an appropriate weighted average cost of capital (WACC).

Risk allocation mechanisms within the IMs

55. The Consultation Paper also notes existing mechanisms that allocate risk between parties: the fact that 100% of commissioned asset values can be recovered, the form of control for price-quality paths, price-path reopener provisions, allowance for pass-through and recoverable costs, indexation of the regulatory asset base and the price path, and the option to apply for a CPP. We discuss these briefly below, except the form of control which is considered in the next section.

Recoverability of capital investments

56. EDBs reasonably expect to be able to recover all of their prudent investment costs. The asset valuation IM provides for the full costs of assets to be included in the regulatory asset base (RAB), although we note that the value of assets purchased from related parties may be lower than this. The risk allocation this implies is reflected in the low regulatory cost of capital; as the Commission says it is important to view risk and compensation mechanisms holistically.

57. We also note that whether or not these costs are fully recovered from consumers will depend on the expenditure allowances included in price paths for non-exempt EDBs, and the target revenues for exempt EDBs.

58. We note that these investment costs are assumed to be recovered over a long period, with depreciation recovery periods in the IMs extending from 15-70 years, with the majority of asset categories assigned asset lives (for depreciation purposes) of 35, 40, 45, 55, 60 and 70 years. In addition, due to RAB indexation, the recovery profile is tipped towards the later years in an asset's life. Thus, EDBs are making investments on the understanding that they can expect to continue to recover their prudent investment costs made now, across a lengthy future period.

[2] Consultation Paper, paragraph 108.

59. The Consultation Paper highlights the risks associated with inefficient investment. The recent capex incentive scheme introduces additional penalties for non-exempt EDBs who exceed capex allowances in price paths. These allowances are also determined using a capping approach which anchors the allowances to historical benchmarks. Penalties already exist to some extent as investment is not fully recovered in a regulatory period if it exceeds price path allowances. We also note that consumers generally benefit from investments in assets which are used to deliver electricity services - while there is a cost; there is also a service which comes with that cost. Accordingly we suggest that consumers and suppliers share in the risk of investment.

60. The topic of asset stranding raised in the Consultation Paper suggests that ongoing technological developments may make EDB investments redundant. As discussed further in the emerging technologies section below, it is not clear at this stage whether there will be a risk of significant asset stranding in the future. Network utilisation may change, and the types of investments made by EDBs are expected to evolve as cost effective new technologies emerge – as they have done in the past. While asset stranding is a possibility, at this stage it appears that substantial stranding of assets seems unlikely.

Price path reopeners

61. The EDBs which support this submission endorse being able to reopen DPP and CPP price paths for catastrophic events and change events or to address errors or misleading information. We do not see a pressing need to revisit these issues, particularly now the catastrophic event re-opener has been included for DPPs.

62. However, as CPPs are prohibitively complex and costly, we consider that there would be significant value – to consumers and suppliers – in allowing a reopener to address particular aspects of a DPP that do not work for individual EDBs and their consumers. In this respect we note that it is in the interests of consumers and suppliers for the DPP to fairly reflect the 'business as usual' circumstances of a non-exempt EDB and its network. It is not appropriate, for example, for the DPP revenue allowances to provide insufficient funds for a supplier to be able to reasonably meet the DPP quality standards and earn a normal return over the regulatory period.

63. The low cost approach to setting DPPs is risky as industry wide approaches are adopted. These are never going to suit every EDB, and yet the cost/complexity/risk hurdles and time delays in acquiring a CPP means that in practice a CPP will not be used to remedy a discrete issue in a DPP. We do not consider that the CPP IMs are designed for this situation and nor should they be. A simple solution is to allow for a DPP to be re-opened for a single issue where the assumption/approach is clearly inappropriate for an EDB for the DPP regulatory period, and the impact of that assumption on the business meets the existing re-opener materiality thresholds.

64. A further solution is to expand the IMs to include allow for single issue CPPs – similar to the 'quality only' CPP option which currently exists.

Pass-through and recoverable costs

65. The treatment of pass-through and recoverable costs has recently changed with the introduction of the pass-through balance mechanism and a series of additional recoverable costs. Pass through and recoverable costs provide a mechanism for EDBs to recover fair costs incurred in providing electricity lines services which they have little control over, or which are uncertain at the time prices are set.

66. We note that the recent DPP reset included changes to this aspect of the DPP and CPP IMs, in order to introduce new incentive mechanisms, and also to improve the operation of this aspect of cost recovery under DPPs and CPPs. The EDBs which support this submission do not believe there is a need to make further changes at this time, because the recent refinements need to bed in before they are reviewed.

Indexation of the asset base and price path

67. The Consultation Paper discusses the current treatment of inflation within the IMs, although the Consultation Paper provides little explanation in this respect, other than at a very high level.[3]

68. We suggest that as this is a complex topic area, the Commission could provide more detail about how forecast and actual inflation are accounted for in the various regulatory mechanisms, and in particular how this is consistent with:

    - providing suppliers with compensation for prudently and efficiently incurred costs;
    - earning normal returns; and
    - outcomes produced in competitive markets.

69. We suggest that a worked example would greatly assist in this regard.

Option to apply for a CPP

70. We have previously submitted[4] that the option to apply for a CPP is not an option that is realistically available for many non-exempt EDBs. This is due to the costs, resource commitments and risks involved in a CPP application and assessment process, which potentially outweigh the remedies available to smaller suppliers for moving from a DPP to a CPP. This topic is discussed further below.

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[3] Consultation Paper, paras 122-123

[4] For example, PwC Submission on behalf of 19 EDBs, Submission to the Commerce Commission on Proposed Default Price-Quality Paths for Electricity Distributors From 1 April 2015, 15 August 2015

Form of control for price-quality regulation

Overview

71. The Consultation Paper states that an issue for the IM review is the form of control that applies to non-exempt EDBs and other regulated suppliers that are subject to price-quality regulation.

72. There are various options available including:

- the weighted average price cap (referred to from this point on as a "price cap") that currently applies to non-exempt EDBs and gas distribution businesses;
- a full revenue cap (i.e. a cap with a wash-up to ensure no more or less than allowable revenue is earned) as currently applies to Transpower; and
- a further option which falls between the two above is the type of revenue cap that currently applies to gas transmission businesses (GTBs), in which the GTBs bear some demand risk but not as much as under a price cap.

73. We agree the IM review should examine this topic and carefully consider the advantages and disadvantages of each option. We consider that this is appropriate for the IM review because:

- we can draw on the experience with the three options outlined above, which was not available when the IMs were first determined;
- there may be circumstances which have changed since the IMs were determined, for example, the ability to forecast real revenue growth may become more complex as consumer demands change; and
- we can draw on recent international experience.

74. Broadly speaking, we support a form of control that improves simplicity and minimises compliance costs and forecasting risk. We are interested to note that the Australian Energy Regulator (AER) has recently moved in the direction of applying revenue caps to the electricity distributors it regulates.

75. We do not consider that there is a clear case for either a revenue cap or a price cap at this time, and therefore we encourage further investigation into this topic, before a draft decision is reached. In the remainder of this section we set out some of our thoughts on the potential benefits of retaining the status quo, or moving to a revenue cap.

Potential benefits of remaining under a price cap

76. We note that price caps:

- have been a feature of Commerce Act regulation for over a decade and therefore are familiar and well understood;
- ensure incentives are in place for connecting new customers in an efficient manner;
- may encourage EDBs to set prices in a way which maximises allocative efficiency. We understand that the AER has recently concluded that these positive incentives are unlikely to exist in reality for most Australian networks;

- provide more flexibility in meeting sudden increases in demand on a network, and enabling the EDB to recover any significant costs that might be associated with meeting that demand; and

- create some compliance risk when restructuring prices. The ability to reform tariffs will be an important tool for EDBs as they seek to improve pricing structures and send efficient price signals to consumers. The regulatory settings should make it easier, not harder, to adjust price structures. A different compliance approach should be applied if price caps are retained, such as an unders/overs regime where over-recovery is washed up in a future year without a formal compliance process taking place.

Potential benefits of moving to a revenue cap

77. In contrast, we note that revenue caps:

- would avoid the need for the Commission to forecast real revenue growth in order to set the DPP starting price for non-exempt EDBs. EDBs and consumers would then no longer be subject to the risk that the Commission's demand forecasts will be wrong.[5] We have previously raised concerns about the inaccuracies in the DPP real revenue growth forecasts. If the Commission retains a price cap, we recommend it spends significant time and resources developing a new and better way of forecasting real revenue growth;

- could make it easier to manage the emergence of new technologies that may change demand patterns on the network, while still recovering allowable revenues. If demand patterns change a revenue cap may become more appropriate, particularly if demand is less predictable. In general, suppliers can do very little to control demand on their network – influencing demand for a product with low price elasticity is a difficult challenge, made even more difficult by regulatory restrictions on setting efficient price structures (e.g. the low-fixed charge tariff option regulations);

- would make it easier to implement price restructures; and

- would mitigate the risk of losing revenues following a catastrophic event. However, we note this risk only exists under a price cap because of the Commission's decision on Orion's CPP application, where it decided that Orion could not recover the revenues lost between the Canterbury earthquakes and the start of the CPP..

Linkage to regulatory WACC

78. Finally, we are concerned by the comment in the Consultation Paper that changing the form of control could result in a change to the regulatory WACC.[6] As discussed in the ENA submission on the Consultation Paper there does not seem to be a strong evidentiary basis for this view.

79. If the Commission has evidence suggesting that the WACC could change as a result of changing the form of control, we request this is put on the table early for submitters to review. If the Commission does not have any such evidence, we request the Commission confirm as soon as possible that it is unlikely to change the WACC based on the form of control. This would mean the debate about the form of control can focus on which form of control delivers the best commercial and consumer outcomes, and not an esoteric and probably unhelpful discussion about systematic risk.

[5] We note that this risk is lower under a CPP, because the supplier proposes a forecast, which the Commission then assesses.

[6] Consultation Paper, paragraph 110.

DPP and CPP interactions

80. It has been suggested that the IMs could be improved in the way in which DPPs and CPPs interact. This refers to parameters which underpin the price paths determined in CPPs and DPPs, where those parameters are derived from IMs. At the point a supplier steps from a DPP to a CPP some parameters which previously applied in a DPP are updated with more recent information.

81. The Consultation Paper states that *"changes in the value of some parameters may affect the incentives on suppliers to seek a CPP… those incentives may not be in the long-term interest of consumers."* In this respect the Consultation Paper discusses the variance in WACC estimates used for DPPs and CPPs.

82. In principle, the regime should ensure that DPPs apply to most non-exempt suppliers most of the time. To achieve this, DPPs need to include reasonable forecasts of capex, opex and revenue growth for each supplier.

83. CPPs should only be necessary to address unusual circumstances such as a catastrophic event or a major change in expenditure requirements that could not have been foreseen and accommodated within a DPP (including a step-change in quality to better meet consumer preferences).

84. We consider it is important that the IMs support this outcome, and importantly do not introduce other variances which may obscure it.

85. We also note that resolving any questions about alignment between DPP and CPP parameters will not address the most significant barrier to CPPs being a useful alternative to the DPP. This barrier is the cost/complexity/risks of making a CPP application, which outweigh the CPP benefits available to most non-exempt EDBs, particularly smaller ones.

DPP and CPP WACC alignment

86. Currently the cost of capital estimates that are used to determine DPPs and CPPs vary as these estimates are determined at different times. The Consultation Paper suggests that if the CPP WACC is higher than the DPP WACC, firms subject to a DPP may have an incentive to apply for a CPP even if the DPP settings are appropriate for that firm. Similarly, if the DPP WACC is higher than the CPP WACC, firms subject to a DPP may choose not to apply for a CPP even if the DPP is inappropriate and not in the long term interests of consumers.

87. We agree this is a valid issue to consider and there are several options available to address it. Table 1 below summarises the available options and the degree of alignment they would deliver.

Table 1: Options for better aligning CPP and DPP WACCs

Options to perfectly align the CPP and DPP WACCs	Options to improve the alignment between CPP and DPP WACCs
Set the CPP WACC equal to the DPP WACC	Use long-term averages to set WACC parameters
Update all variable WACC parameters annually	Update cost of debt WACC parameters annually

88. We support careful consideration of these options and the various implications of them. We note that the WACC alignment issue is being fast-tracked to assist suppliers which may apply for a CPP in 2016. However, the need to complete the fast-track review by February 2016 does not prevent further consideration of the issue later in the IM review process, if necessary.

Setting the CPP WACC equal to the DPP WACC

89. The CPP WACC could be set directly equal to the prevailing DPP WACC, for any given year. A complexity with this approach would be adjusting the CPP price path to reflect any change to the DPP WACC that occurs during a CPP period. One potential method for addressing this is as follows:

    - the CPP price path could initially be set using the DPP WACC prevailing at the start of the CPP period; and
    - the CPP price path could be reset at the same time as the next DPP is reset accounting for the change in WACC. Allowable revenue over the CPP period is recalculated based on building block allowable revenue (BBAR) updated for the new WACC from the date of the DPP reset.

90. This option delivers alignment between the CPP and DPP. It creates some uncertainty over the CPP price path as the DPP reset WACC will not be known at the time the CPP is determined. In addition, there are other assumptions in a CPP price path which align with the WACC, which could be considered.

Updating (some or all) WACC parameter values annually

91. Currently the risk-free rate and the debt premium are updated at the start of each new regulatory period (all other WACC parameter values are fixed). These parameter values could instead be updated annually. We note that overseas jurisdictions which use this approach typically only update the cost of debt, not the cost of equity.

92. While the Consultation Paper discusses this in the context of DPP and CPP alignment, using annually updated parameter values is a wider issue. In particular, the following points also need to be considered:

    - a number of other components of the BBAR forecast will change during the period – for example, opex and capex forecasts, inflation forecasts, and growth forecasts. Under this option, only the WACC would be updated. Consideration should be given as to whether there is a suitable rationale for treating the WACC differently to the other BBAR components in this respect;
    - if annual updating of the WACC is to be applied, a method for implementing this in practice will need to be devised. Both Ofgem and the AER effectively reset the price path at the start of every year, with the BBAR series for the regulatory period recalculated using the updated WACC value (in a similar way to that described above); and
    - this approach would create uncertainty for consumers and suppliers over the regulated revenues in DPP and CPP periods. This lack of certainty over the price path is a trade-off for reducing the potential for the regulatory WACC to diverge from the underlying market cost of capital. The extent to which this trade-off is appropriate will need to be considered.

Using longer-term averages for bond yields

93. Currently, the risk-free rate and debt premium are determined using bond yields over a month-long period. This approach leads to volatility in these parameter values over time. Extending the historical period over which the bond yields are averaged would reduce this volatility. As a result, both DPP and CPP WACCs would be expected to become more stable over time. In this respect we note:

    - the period for averaging yield data is to some extent a trade-off. Shorter periods result in a more 'current' estimate of the parameter. Longer periods can average out fluctuations in the business cycle, which is desirable if the future regulatory period is sufficiently long that it might include different parts of the cycle;

- long-term averages recognise that much of an EDB's debt is in existence at the start of the regulatory period. Using the current cost of debt effectively assumes that the business will re-finance all of its debt at the start of the regulatory period, which is unlikely to be the case. The use of longer-term averages is a better way of accounting for the different timings of actual debt issuance; and
- longer-term averages can also provide greater certainty for stakeholders seeking to forecast regulatory revenues in future regulatory periods. In such exercises, forecasting the WACC is one of the most difficult and sensitive assumptions.

94. We note that longer-term averages can be implemented with or without the other options discussed above. For example, longer-term averages could be implemented with no further changes to the cost of capital IM. Alternatively, they could be implemented in conjunction with annual updating.

Future impact of emerging technologies

95. The Consultation Paper notes that many stakeholders have identified emerging technologies and their impacts as a relevant topic for the IM review. The Consultation Paper indicates that the Commission would like to better understand the likely impacts of emerging technologies on how electricity networks (in particular) are managed and what the implications are for the IMs.

96. We agree this topic should be considered as part of the review. We broadly agree with the summary in the Consultation Paper setting out the changes and their potential implications. However, we would emphasise that it is not sufficient to draw on international experiences and expect the same patterns to emerge here. The New Zealand context needs to be considered, including:

    - weather patterns;
    - winter peaking load;
    - subsidy free investment in distributed generation;
    - the high proportion of renewable grid-connected generation; and
    - the relative costs between network-delivered electricity and new technologies.

97. We see the emergence of affordable battery storage as one of the key developments that could have a substantial impact on network usage patterns.

98. The EDBs which support this submission consider that electricity networks will continue to provide an essential and valuable service to consumers for some time to come. Patterns of use and demand for future assets may change, but existing assets currently provide an important service to consumers and we expect this to continue.

99. EDB's information and analysis of the impacts of new technologies are continuing to improve. While the rate of change is open to debate, the impacts of some of the technologies which are mentioned (solar PV, TOU meters and electric vehicles) are currently low. Other changes such as the impact of energy efficiency initiatives have been ongoing for some time. EDBs have also actively invested in technology (supplemented by pricing signals) to assist with load control for many years.

100. We consider that the IMs may be able to be amended in ways which better accommodate increased uptake of emerging technologies and changing consumer demands.

101. In this respect we note that:

    - new technologies may be mostly taken up by consumers from higher socio-economic groups, meaning they may pay lower lines charges and EDBs would then be required to recover more from lower socio-economic residential consumers and possibly also small businesses;
    - non-exempt EDBs are generally not rewarded for innovating and testing new technologies. Where these investments deliver savings in the long term, EDBs will not be rewarded for making them, even though they could deliver lower prices overall. We note that as it will not always be clear what quality of supply the new technologies will deliver, such investments may impact on network quality performance;

- new technologies could provide particular benefits by enabling EDBs to supply remote customers more cheaply, to the benefit of consumers overall. However, EDBs are obliged by statute to maintain supply to pre-1993 connections unless the consumer agrees to alternative supply. This means the most affordable solution will not always be able to be delivered;
- it will be important for EDBs to deliver price signals to consumers that efficiently signal the use of the network and the effect of new technologies on the network. Regulations such as the low fixed charge regulations (which we recognise are not the responsibility of the Commission) impede EDBs' ability to price efficiently; and
- new technologies may deliver lower life time cost options for supplying consumers, but may also increase network complexity and require new activities such as the 'distribution system operator'. It is not clear which effect will outweigh the other and we note it should not necessarily be expected that network costs will fall, particularly in the short to medium term, as new technologies develop.

102. We suggest that incremental changes should be considered now to improve the IMs to help EDBs prepare for the emergence of new technologies, without making more substantial changes until more information is available.

103. Possible ways for the IMs to address the issues discussed above could be to:

- reduce the standard asset lives (for all or some assets) within the IMs to allow cost recovery to occur over a shorter period;
- extend the scope of assets included in Schedule A to accommodate emerging technologies which may be used to provide electricity distribution services (this would avoid the need to comply with 'no-standard life asset' rules for such technologies);
- review the asset revaluation method and the definition of asset disposals (which may also deliver additional cost and complexity savings by improving alignment with GAAP); and
- provide specific incentives for EDBs to invest in research and development in relation to new technologies.

104. We also encourage the Commission to support efforts to improve pricing flexibility to assist EDBs to commercially manage the transition to new technologies and deliver efficient pricing structures. This could include a wash-up mechanism in DPPs and CPPs to account for overs and unders which may occur as a result of changes to pricing structures.

105. Finally, we note that one of the key challenges for the regulatory framework in considering the impact of emerging technology does not sit within the IMs. Future capex and opex allowances and quality standards for the purpose of price-quality regulation are expected to be one of the more immediate challenges in attempting to estimate the impact of emerging technologies on EDBs. The methods for determining each of these do not fall within the scope of the IMs.

Responses to questions asked by the Commission

106. The Consultation Paper identifies issues and asks questions about the impact of new technologies. We respond to these queries in turn below.

i. Do regulated firms have the right incentives to make expenditure decisions that are for the long-term benefit of consumers?

Incentive-based regulation sends useful signals for EDBs to find ways to deliver services at a lower cost while maintaining quality of supply. However, as discussed above, EDBs do not have strong incentives

to innovate where savings would take longer than five years to match the cost of the innovation, even where the long-term effect would be lower costs.

ii. What should the scope of regulated services be?

The scope of regulated services should be that any activity that provides electricity lines services to consumers is a regulated service, including activities that defer or delay costs of providing the service, and excluding contestable services. We consider that the cost (and asset) allocation IM currently provides an appropriate method for identifying these costs and services.

iii. Should a grid-scale battery storage investment by an EDB that defers a network reinforcement fall within the RAB?

Yes, it should, and it falls within the RAB under the current IMs. Where an EDB makes an investment in an alternative technology to defer traditional network reinforcement, it is clearly an investment that is being undertaken to provide electricity distribution services and should therefore be included in the RAB. Where the investment is used to supply both regulated and unregulated services the sharing component of the cost allocation IM applies.

The Consultation Paper questions what would happen if a third party made this investment. We are not sure why this is relevant – if the third party made this investment to sell the service to the EDB, that cost would be regulated opex for the EDB. If the third party invested in grid-scale battery storage for a different reason then it would not be providing electricity distribution services and should not fall within the RAB.

If the Commission's concern is that EDBs may use their regulatory position to undermine potential competitors, this would be appropriately dealt with under Part 2 of the Commerce Act rather than Part 4. The Commission should be careful to focus on the purpose of the investment rather than the type of technology used. Otherwise EDBs may be locked into investing in traditional assets.

iv. Price signals should encourage the efficient adoption and use of emerging technologies. Consumers should receive the signals from network prices

We agree with these statements. A key barrier to enabling EDBs to respond efficiently to new technologies is the regulatory constraints that limit pricing efficiency, most notably the low-user fixed charge regulations, and the ability of retailers to re-bundle network prices. We recognise pricing methodologies are the responsibility of the Electricity Authority and the regulations were promulgated by the Minister of Energy, but encourage the Commission to work with the Authority and MBIE to ensure that barriers to efficient pricing are removed.

v. Risk of asset stranding

We consider that it is not clear at this stage whether there will be a risk of significant asset stranding in the future. As stated above, we expect that network utilisation may change, and the types of investments made by EDBs are expected to evolve. Thus while we recognise that asset stranding is a possibility, at this stage substantial stranding of assets appears unlikely.

vi. Uncertain scale and timing

The Consultation Paper is correct that the scale and timing of the emergence of new technologies is uncertain. We discuss implications for this above.

vii. Energy efficiency and demand-side management incentives

We consider that non-exempt EDBs need better incentives to invest in energy efficiency and demand-side management initiatives. The energy efficiency allowance introduced in the 2015 DPP price-quality path is a useful start but does not go far enough. As we have previously submitted, it should be extended to cover tariff-based measures and EDBs should be permitted to apply for in principle pre-approval of the allowance before commissioning an investment.

viii. Aligning expenditure incentives

It would be helpful to review whether the current IRIS settings promote the right balance between opex and capex savings for EDBs.

ix. Is the current framework biased in favour of business as usual expenditure?

It is challenging for most businesses in most industries to move away from "business as usual" expenditure as it will generally be easier to invest in known technologies that the business understands and has used successfully in the past. To overcome this natural incentive to favour investment in known technologies, there may need to be targeted incentives to innovate and to apply that innovation in scenarios that are more than just pilot programmes and trials.

Cost of capital issues raised by High Court

107. In its IM merits appeal judgment of December 2013, the High Court raised concerns regarding several aspects of the cost of capital IM. It suggested the Commission should review these aspects of the IM. The aspects are:

- the WACC percentile used for price setting purposes;
- the use of the SBL-CAPM;
- the use of the term credit spread differential allowance; and
- whether a split cost of capital approach, where a higher WACC is applied to new investments than to sunk investments, should be adopted.

108. To fulfil the High Court's request, the Commission now proposes to review these items as part of the full IM review.

WACC percentile

109. The WACC percentile issue was addressed last year. We maintain the view that it was inappropriate to reopen the IMs to consider that specific issue in isolation and there was insufficient evidence to justify a reduction in the WACC percentile.

110. Unless there is material new evidence from a number of sources which has come to light, we do not consider that the WACC percentile should receive significant attention as part of this IM review.

Other topics raised by the High Court

111. We do not consider the other topics raised by the High Court warrant detailed attention either. In this respect we note:

- the SBL-CAPM approach is widely used in New Zealand and had significant support when it was adopted in the IMs in 2010;
- the basis for having a term credit spread differential allowance remains valid, although this may be superseded if the Commission chooses to take a different approach to calculating the cost of debt; and
- the split cost of capital approach would damage investment incentives, create real implementation problems and we are not aware of it being applied by other regulators – it does not need to be given much credence.

WACC volatility

112. A further WACC issue that may indicate there is a problem with the current IMs is the volatility of WACC estimates. The WACCs that have been determined for price-quality and information disclosure purposes under the IMs have been more variable than we expected. This could be addressed by the mechanisms we discussed above, for example the use of a longer averaging period for setting the WACC parameters (as the AER has recently done in Australia).

CPP rules and processes

113. The Consultation Paper notes that there are opportunities to improve the rules and processes for making CPP applications.

Fast-track review topics

114. Since the Consultation Paper was published, the Commission has decided to progress this topic through its fast-track process with a decision on improvements to CPP rules and processes planned for November 2015.

115. We support the detailed submission made by the Electricity Networks Association in 2014[7] on improvements that can be made to the CPP IMs and the CPP submission and assessment processes. In particular the EDBs which support this submission support the ENA's suggestions for simplifying and reducing the costs of CPP applications, by:

- reducing the scale and complexity of the information requirements and aligning them better to the information retained by each EDB and the information disclosure requirements;
- clarifying and targeting the roles of the verifier, independent engineer and auditor;
- clarifying consultation expectations and requirements;
- retaining the verifier for the post-application review (to avoid re-work as a new expert gets up to speed); and
- establishing clearly the end of CPP process for transitioning to a DPP.

116. We support changes to achieve these aims being made as part of the fast-track process; however we note that there is considerable effort required to modify the CPP IMs to appropriately reflect these objectives. Accordingly we consider that introducing additional flexibility in how an applicant responds to the CPP IM should be a priority for the fast tracked amendments, in addition to the WACC alignment identified earlier.

117. A more considered, and hence lengthy process including allowing for sufficient inputs from stakeholders is required to undertake the substantial redrafting which is required to the CPP IM (including Schedules B, C, D, E, F and G of the IMs).

Making the CPP cost effective for all

118. The changes being considered for the CPP IM are expected to contribute to reducing the cost and complexity in applying for a CPP, but they will not take enough costs out of the CPP process to make it a valid option for all EDBs. The Commission needs to find a way of making the CPP a viable alternative to the DPP for the smaller non-exempt EDBs.

119. We note that the DPP includes a mechanism for providing EDBs an additional allowance to reduce the probability of applying for a CPP. However, this does not make a CPP any more or less viable; it simply increases allowable prices under the DPP. We also note that the current DPP only includes this allowance for three EDBs.

[7] Electricity Networks Association, Feedback on setting Orion's customised price-quality path, 11 April 2014

120. In order to make the CPP a more viable option we suggest that the CPP IM should be less prescriptive. The IM should allow an applicant to present their case for an alternative price path and quality standards using information which is directly relevant to their application, and is based on information retained by the EDB which supports the EDB's own planning and operating practices. While we understand the need for the Commission to receive comprehensive information in support of a CPP proposal, we consider the IMs can be substantially improved by allowing EDBs more flexibility in how they compile this information. This is not inconsistent with the expectation that well run EDBs will have sufficient information available in support of their application.

121. In particular we consider that the CPP IMs should:

- allow for a single-issue CPP (or "a few issues" CPP), which could be a cost-effective route to helping EDBs meet the needs of their consumers. EDBs should be able to apply for a CPP solely to consider large one-off investments or circumstances where a particular DPP forecast does not quite work for them. Examples might include:
    i. where a small EDB needs to replace a substation or install a new GXP this can be a one in 45-year investment and will never be captured by capex forecasts based on historical averages; and
    ii. where revenue growth forecasts are set based on regional averages but then applied to a network in a lower-growth part of a region; meaning the regional forecast over-states growth within the network;
- where a single issue CPP application is made – including a quality only CPP – restrict the scope of the Commission's assessment (including the information requirements), to those which are directly relevant to the issue in question;
- enable EDBs to use their Asset Management Plans as the basis for their CPP applications. The key factors supporting the application should already be present in the AMP and the CPP application should build on this information incrementally in support of the proposed CPP price path and quality standards;
- tailor the information requirements to the size of the CPP applicant, e.g. reducing the number of projects that need to be reviewed;
- requiring less information up front with the application but with the ability for the Commission to request further detail on particular topic areas where reasonably required; and
- allow the abnormal costs incurred by the EDB in preparing a CPP and responding to the Commission's assessment to be recovered – this cost recovery is consistent with the CPP reflecting the long term interests of consumers.

122. We also want to emphasise the importance of clarifying the consumer consultation requirements. It became clear in the Orion CPP application process that the Commission had expected Orion to consult on various options with its consumers, but this is not what the CPP IMs require. It is important that the Commission make it as clear as possible in the IMs what it requires from consumer consultation. We also submit that, where a CPP applicant has followed the requirements in the IMs, the Commission should refrain from criticising that applicant's consultation process.

Transition back from a CPP to a DPP

123. Although this topic is not raised in the Consultation Paper, one further problem with the current CPP IMs is that they are silent on the process for transitioning a supplier from a CPP back onto a DPP. The

Commerce Act permits the Commission either to roll over prices or to set new prices provided these are notified to the supplier at least four months prior to the end of a CPP.[8] We do not believe this provides sufficient certainty for suppliers considering a CPP application about how they will be treated at the end of the CPP period.

124. We recommend the IMs include the process and timings for determining whether a supplier transitioning from a CPP remains on the CPP price path or a new price path is set, and how the new price path will be determined, if that is the Commission's decision.

[8] Section 53X(2).

Complexity and compliance costs

125. The Consultation Paper suggests the IM review could find ways to reduce complexity in the IMs and the compliance costs they create. We strongly support this objective. The compliance burden created by Part 4 regulation on the small to mid-sized EDBs is excessive and reducing this should be a key focus of the IM review.

Information disclosure

126. The purpose of information disclosure regulation is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of this Part is being met.[9] It is not clear that information disclosure is currently fulfilling this purpose or that this has been considered so far as part of the IM review. We have seen only limited attempts to use disclosed information for anything other than informing price reset decisions. There is a sizeable bulk of disclosure information that does not appear to have been used very much, if at all, by anyone, but is costing all EDBs to produce.

127. The scale and complexity of the disclosure requirements may also be undermining the purpose of information disclosure. Completing the disclosures means EDBs need to make numerous judgements about how to disclose items, and these judgements may vary across EDBs. In addition, and as we have previously submitted, we consider that the disclosures currently provide too much data, and not enough information, about the performance of regulated suppliers.

128. There are numerous issues where there is a cross-over between the IMs and the information disclosure determinations. These cross-overs appear to have created unhelpful barriers to improving the ID determinations in areas where IM changes would be required.

129. Therefore, we encourage the Commission to include in the IM review process the outstanding actions which are necessary to correct and improve the IDD. The IDD applies to all EDBs, and hence it is an important regulatory mechanism in the context of Part 4.

Related party transactions

Consistency between input methodologies and information disclosure

130. The current design of the related party rules gives rise to unnecessary confusion and complexity. Capex related party transactions are addressed in the IMs, but opex and revenue related party transactions are addressed in ID. In addition, the CPP IM includes provisions for forecasting all related party transactions, including opex and revenue.

131. From an IM perspective, it is only the capex and CPP rules which are in scope, but it is reasonable to extend the discussion to the ID opex and revenue rules to ensure consistency – especially as this information feeds into the DPP IMs. The Commission is able to amend ID at any time, but to date – despite recognising that there are issues with related party rules in ID – it has not progressed this work stream due to the linkage with the IMs via capex.[10]

132. We consider that it is important to improve the consistency between the ID and IM requirements to help suppliers to apply the options and rules. This could be achieved by:

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[9] Section 53A.

[10] Commerce Commission, 'Amendments to information disclosure determinations for electricity distribution and gas pipeline services 2015: Final reasons paper', 24 March 2015, Appendix C.

- better aligning the sequencing of the valuation options;
- ensuring the terminology is consistent and unambiguous; and
- ensuring the valuation criteria which have substantially the same effect are expressed consistently.

133. Further refinements could be to adjust the third party test to permit the inclusion of other parties (who are not party to the transaction) but who may also be related parties. This would enable the equivalence test to be met by entities which operate under a shared service model, where the terms of the services offered are consistent across a number of parties, including related parties which are not party to the transaction in question.

134. In addition the Directors' certification option may only be used where none of the other options are available. This is problematic as some options may be technically available but would not lead to sensible outcomes – ie: outcomes that are consistent with those of workably competitive markets. This is because a number of the current options restrict the value of related party transactions to less than those that would be established on an arms' length basis. This anomaly needs to be removed.

Directly attributable cost

135. The cost allocation IM allows for the 'directly attributable costs' and 'not directly attributable costs' incurred in the provision of a regulated service to be allocated to that service. Due to different operating models and cost accounting practices, the IM is deliberately flexible as to the boundary between directly attributable and not directly attributable. The outcome is that the sum of these two components of cost provides a fair allocation of costs to the regulated service.

136. We submit that the reference to the term directly attributable cost in the related party rules is not appropriate, unless not directly attributable cost is also included. This is because directly attributable cost may mean different things to different businesses and for different services.

137. In this respect we note that in responding to questions as to how to interpret the related party rules, the Commission has provided the following guidance:[11]

- shared costs are unable to be included in 'directly attributable costs';
- overhead costs which are shared between projects undertaken by contractors are not directly attributable, even when they are recovered through margins included in hourly rates which can be specifically attributed to individual projects; and
- it is reasonable to apply a mark-up of up to 17.2% on the directly attributable costs associated with new assets constructed by a related party, when using the Directors' certification option for capex.

138. Further, there is a narrower definition of gross margin for related party contractors than independent contractors (based on the typical convention of recovering costs via unit rates), which may be inconsistent with the derivation of the 17.2% margin.[12]

139. The IMs also use directly attributable cost in the context of GAAP for capex, but GAAP does not recognise the term, and under GAAP it is profit margins, not shared costs, which are eliminated.

[11] Sources include ID Issues Register item 432 and Commission correspondence with EDBs.

[12] Information Disclosure clause 2.3.6(1)(b), which relates to opex. There is no equivalent capex option in the IMs, although as noted above, the Commission has indicated that this principle may be applied to capex in certain circumstances.

140. Accordingly, the EDBs which support this submission suggest that a key change to improve the workability of the related party rules would be to remove the linkage to the cost allocation IM term 'directly attributable cost' in order to:

- ensure that related party charges can include recovery of both direct costs and shared costs;
- ensure related party arrangements are not penalised relative to in-house models or external provider models;
- ensure related party costs are valued consistently with arms' length prices when the qualifying criteria are met; and
- be consistent with the NPV=0 economic principle which underpins the IMs.

Related party rules in the CPP IMs

141. We also note that the CPP IM related party information requirements are too onerous, and the forecasting methods specified in the CPP IM are not able to be applied in practice. For instance the CPP IM requires detailed information to be included in a CPP proposal about every actual and forecast related party transaction over a 12 year period. The information for each transaction is listed in Clause D17. Not only is it impossible to provide this information on a forward looking basis, an EDB may have many different contracts for a wide range of services with related parties. It is not necessary or reasonable to require this quantum of supporting data. An explanation of the processes undertaken and a sample of evidence supporting the valuation options applied in historical disclosures are sufficient.

142. Further, it is not possible to fully meet the valuation requirements on a forward-looking basis (e.g. the test relating to competitive tenders implies that the competitive tender for all work under a CPP must have been completed before the application is made). The evidential requirements in clause D17 are also challenging to meet on a forward-looking basis as much of this information is, quite reasonably, not available at the time a CPP application is made – e.g. it will not be clear during the Assessment Period which projects each related party will be associated with across the CPP period.

Treatment of taxation and cost allocation

143. The Consultation Paper raises the regulatory tax and cost allocation methodologies as being potential areas where the current IMs could be simplified. We are not convinced there is value in seeking to simplify these parts of the IMs and the aim should be to avoid unnecessary system changes for IMs that are working well.

144. While the deferred tax methodology is more complicated than the tax payable methodology, EDBs now have several years' experience in implementing it. We believe it would be more expensive to change the approach and the supporting systems and processes. We consider that the original rationale for the method remains valid at this time.

145. The cost allocation methodology can be applied successfully to a range of different business models and does not cause particular compliance problems. Seeking to prescribe the approach more closely would add cost rather than remove it and may impede the use of efficient business structures. We also see value in the various options – ABAA, ACAM, OVABAA – remaining in the IMs. Now that these have been developed there is only limited value in removing them from the IMs. We also consider that some of these features may become more widely used in the future as EDBs invest in non-traditional assets and services in response to consumer demand.

Cost definitions

146. The Consultation Paper suggests cost definitions could benefit from review but does not say which definitions had been identified as potential problems. We submit that there is value in ensuring the definitions of cost and asset values are as consistent with GAAP as possible, as this will assist understanding and alignment with other financial reporting for all EDBs. There are components of the RAB IM where this alignment could be improved – for example the treatment of disposals and finance during construction.

Treatment of transactions

147. Although not discussed in the Consultation Paper, we consider there is scope to improve the parts of the IM and DPP determinations that regulate transactions involving regulated suppliers.

148. For example, we are aware of the following problems with the current IMs:

- the IMs restrict the value of assets purchased from another regulated supplier to the other supplier's closing RAB value for the asset. However, transactions to purchase assets incur project costs that GAAP permits firms to capitalise. The IMs are ambiguous on how these costs are recovered;
- Transpower does not have deferred tax while EDBs do. When EDBs purchase assets from Transpower there will not be an opening deferred tax balance and the IMs are ambiguous about how this should be handled;
- the IMs are also ambiguous as to the method that should be used to calculate the specific adjustments to (i) the deferred tax balance, (ii) the unamortised balance of initial differences, and (iii) the weighted average remaining life in the initial differences calculation, to account for acquisitions and disposals. The IMs state that an adjustment should occur, but do not explicitly set out an appropriate approach;
- the specification of the deferred tax roll-forward in the information disclosure IMs does not include a specific adjustment for disposals, despite this being included in the IDD;
- the IMs are ambiguous as to what value is added to the 'adjusted RAB' when an asset is acquired from another regulated supplier and that asset's purchase price (and hence the value of commissioned asset) is lower than the prevailing RAB value; and
- under the IMs, when assets are acquired from a related party, their notional tax asset value upon commissioning (which determines its starting regulatory tax asset value) cannot be greater than the value of commissioned assets. However, there may be reasons why the tax asset value should be greater than the commissioned asset value, without compromising the regulatory methods. In particular, if an EDB elects to treat capital contributions as income for tax purposes, then the opening tax asset value for an asset for which capital contributions were collected should be higher than the value of the commissioned asset – but the IMs do not allow this.

Incremental rolling incentive scheme (IRIS)

149. We support the objective of the IRIS, to provide consistent incentives to make efficiency savings in each year of a regulatory period. However, we continue to have significant concerns about whether it is possible to implement an incentive scheme which delivers the desired outcomes within DPP/CPP regulation. We note the increasing complexity of the IRIS mechanisms, and are concerned that there may be unintended consequences which are detrimental to consumers and/or non-exempt EDBs in future due to the unpredictable nature of the incentive outcomes.

150. We also consider that this is one risk which provides a disincentive for making a CPP application. The operation of the IRIS when transitioning between DPPs and CPPs is currently unclear, and given the

consultation to date, appears to require overly complex logic to implement the transitions between DPPs and CPPs, and provide sufficient certainty.

Presentation of IMs

151. We believe the IMs could be presented more helpfully. For example, the cost of capital IM can be interpreted fairly easily as the key items are set out in equations. Taking a similar approach would make the regulatory tax IM, for example, easier to follow.

152. The placing of definitions in various parts of the IMs, ID and price-quality determinations and in the Act can also make it challenging for the reader to find the definition. Use of hyperlinks may be a way of assisting with this.

153. While some complexity is inevitable, we note that the understanding of the IMs has improved greatly with the IDD templates, issues registers, associated workshops and worked examples, and other modelling such as the Commission's DPP price path model. It is expected that these components of the regulatory framework will continue, and will assist stakeholders in applying and understanding the IMs.

Process

154. We would support the Commission placing a great deal of effort into ensuring the IMs it determines in this review are accurate, robust and error-free. This would greatly reduce the costs suppliers will incur when implementing the IMs. With that objective in mind, we recommend the Commission take the following steps:

    - systematically consider and work through all issues raised in previous submissions and submissions on this process to ensure nothing is missed;
    - where the Commission is inclined not to amend an IM in relation to a point raised, it should specifically signal this intent and the reasons for it. This will ensure the Commission's position is clear and any misunderstanding can be addressed in a timely manner;
    - one or more working groups should be established to consider the detail of the proposals being made and how they could work in practice;
    - there will need to be a robust and independent quality assurance process applied at the draft determination and final determination stages for all IM changes, to ensure they are workable and error-free; and
    - the linkages across determinations (IM, ID and price-quality) will need to be considered. Where there are consequential amendments required for ID as a result of IM changes, these should be considered in parallel to ensure the IM changes can be implemented in a practicable way.

155. The EDBs which support this submission would be happy to assist the Commission with this process.