



From the Electricity Networks Association

Response to the Commerce Commission's open letter

Proposed scope, timing and focus for the review of input methodologies

31 March 2015

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

Alpine Energy Ltd
Aurora Energy Ltd
Buller Electricity Ltd
Centralines Ltd
Counties Power Ltd
Eastland Network Ltd
Electra Ltd
EA Networks Ltd
Electricity Invercargill Ltd
Horizon Energy Distribution Ltd
Mainpower NZ Ltd
Marlborough Lines Ltd
Nelson Electricity Ltd
Network Tasman Ltd
Network Waitaki Ltd
Northpower Ltd
Orion New Zealand Ltd
OtagoNet Joint Venture
Powerco Ltd
Scanpower Ltd
The Lines Company Ltd
The Power Company Ltd
Top Energy Ltd
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Waipa Networks Ltd
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1. Introduction

1. This submission responds to the Commerce Commission's (the Commission's) Open letter (the Open Letter) on the upcoming Input Methodology (IM) review.¹
2. The Electricity Networks Association (ENA) appreciates the opportunity to submit to the Commission on the proposals set out in the Open Letter. The ENA represents the 29 electricity network businesses (ENBs) in New Zealand.
3. The IMs are a fundamental component of the Part 4, Commerce Act 1986 regulatory framework which applies to ENBs. We appreciate the Commission's early engagement on its proposed approach to the forthcoming review.
4. In the remainder of this submission, we consider the statutory provisions and framework for IM and the IM review; the proposed timing and process for the IM review, and the potential scope of the review.
5. We note that the topics covered in this submission should not be perceived as the only issues which the ENA considers might be addressed during the IM review, and we anticipate contributing more fully to the review as it progresses.

1.1 Summary

6. In undertaking the IM review, the ENA submits that the statutory provisions set out in sections 52A Purpose of Part 4 and 52R Purpose of Input Methodologies, are of paramount importance. Section 52V also specifies the process that the Commission must follow when undertaking its review.
7. The ENA recommends that it is most important at this stage to determine a clear framework, and process for the review. This is necessary before it is possible to assess which aspects of the IMs should be given the most attention.
8. We suggest that an appropriate process may be one which includes the following key steps:
 - a) develop a formal process for the review, including key steps, timing and protocols;
 - b) undertake a landscape review to assess what has changed since the 2010/11 IMs were determined and how have the IMs performed to date;
 - c) establish the legal and economic framework for the review; and
 - d) undertake technical analysis of potential changes to IMs or new IMs.
9. The ENA also considers that there should be clear expectations about the purpose of the seven year review of IMs, and the circumstances which might lead to other changes in the IMs which may be made in the intervening period.
10. The ENA supports the proposal to:
 - a) review all of the IMs at one time, including those that apply across the electricity, gas and airports sectors. There is sufficient overlap between the IMs for each sector to justify this approach, and accordingly avoid duplicating effort; and

¹ Commerce Commission, Open letter on our proposed scope, timing and focus for the review of input methodologies, 27 February 2015

- b)* review the complete set of IMs for each sector at the same time, because of the interplay between different elements of each IM. To do otherwise raises the possibility of inconsistency or re work if IMs were reviewed sequentially.
- 11. There is no perfect time for the IM review because of the length of the regulatory and pricing periods, and the disjoint between the timing across the sectors. The ENA's primary concern is that if insufficient time is available to complete the review, the scope of the review and the quality of the analysis and consultation processes may be compromised.
- 12. The ENA also recommends that the lessons learned from previous regulatory decision making processes under Part 4 are fully considered when establishing the process for the IM review, including in relation to consultation timing, use of experts and consultation material.
- 13. The ENA does not consider that each IM should be considered in isolation as they form a suite of methods which together are intended to deliver outcomes consistent with those defined in section 52A.
- 14. In determining the focus of the IM review, the ENA: agrees that technological developments which impact on consumer demand for electricity distribution services and the nature of the services that ENBs provide to their connected consumers are relevant to the IM review. We consider these issues apply to the overall suite of IMs.
- 15. In addition to the possible focus areas outlined in the Open Letter, the ENA recommends that the IM review also:
 - a)* seeks to improve the way the DPP/CPP framework operates, by reducing the costs and risks which are currently a feature of the CPP option;
 - b)* addresses issues in the ID IMs, which have been identified but not yet resolved; and
 - c)* considers whether there are opportunities to improve the IRIS IM, which is currently incomplete and largely untested.
- 16. We provide more detailed comment on these points in the body of our submission.
- 17. The ENA's contact person for this submission is:

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2. Regulatory framework

2.1 Overview

18. For the purposes of the Commission's IM determinations, the empowering provisions are included in subpart 3 of Part 4 of the Act. The empowering provisions must be exercised in accordance with:
 - a) section 52R, which states that the purpose of IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to regulation; and
 - b) section 52A, which provides that the purpose of Part 4 is to "promote the long-term benefit of consumers...by promoting outcomes that are consistent with outcomes produced in competitive markets such that...(a) to (d) are met".
19. The purpose of Part 4 will be met if the regulated outcomes under Part 4 are consistent with outcomes produced in workably competitive markets. The Act identifies a number of outcomes in (a) to (d) of section 52A(1), which it assumes will be observed in a workably competitive market.
20. Section 52Y requires each IM to be reviewed no later than seven years after the date of publication, and at seven yearly intervals thereafter.
21. Section 52V prescribes the Commission's process for determining IMs. This applied when the IMs were first determined in 2010/2011, but also applies to the seven year reviews, and for material amendments which may be made to IMs from time to time.
22. We note that section 52V(3) states that '*any work done or action taken (including any consultation) by the Commission on input methodologies before the commencement of this section may be treated by the Commission and any person consulted as work done or action taken under this section*'.
23. While this is not acknowledged in the Open Letter, we assume that following consideration of the responses to the Open Letter, the Commission will embark on the process prescribed in section 52V. We would appreciate clarification of the Commission's intent as regards to section 52V(3), in this respect.

2.2 Framework for the review

24. The Open Letter sets out proposals for the timing, sequencing and specific elements of the IMs which might form areas of focus for the review. The ENA considers that it is most important at this early stage to determine a clear framework and process for the review. The framework needs to be established prior to determining which aspects of the IMs are focussed on, because it will inform this emphasis.
25. Paragraph 30 of the Open Letter proposes that the review should seek to change the current IMs if the alternative:
 - a) more effectively promotes the section 52A purpose;
 - b) more effectively promotes the section 52R purpose of IMs, without detrimentally affecting a) above; and
 - c) significantly reduces compliance costs, other regulatory costs or complexity, without detrimentally affecting a) above.

26. The ENA agrees with the objectives outlined above, however we recommend that at the beginning of the IM review, a decision-making framework is developed. The primary purpose of this is to determine whether to change from an existing IM or introduce new IMs.

Incremental changes to the IMs

27. We note that the Commission has added IMs (in response to merits appeals) and amended existing IMs a number of times to date, well within the seven year review period. The ENA considers that there should be clear expectations about the purpose of the seven year review of IMs, and the circumstances which might lead to other changes in the IMs which may be made in the intervening period.
28. In this respect, we consider that objectives a) and b) in paragraph 25 above are those which are of primary importance for the seven year review. Objective c) may be met by incremental refinements to existing IMs within the seven year period, which do not change the underlying policy intent, and therefore do not introduce regulatory uncertainty. However if there are uncontroversial opportunities for compliance/complexity improvements at the seven year review, then the ENA agrees that these should be included in scope.

2.3 Review process

29. As noted above, it is timely to consider the optimum process for the IM review, and we look forward to further discussion with the Commission on this aspect of the review in due course. In the interim however we suggest that an appropriate process may be one which includes the following key steps:
 - a) Develop a formal process for the review, including key steps, timing and protocols: for example how expert evidence is best included in the process, ie: is there an opportunity to get experts together to discuss and resolve areas of agreement/disagreement;
 - b) Undertake a landscape review – to assess what has changed since the 2010/11 IMs were determined (for example consumer demands, technology), and how have the IMs performed to date (for example the CPP and DPP IMs). This may highlight a need for additional IMs, as well as refinements to existing IMs;
 - c) Establish the legal and economic framework for the review – what criteria should apply when considering changes to the current IMs (this can be undertaken concurrently with step b)); and
 - d) Undertake technical analysis of potential changes to IMs or new IMs, given steps a) to c).

2.4 Recommendations

30. In undertaking the IM review, the ENA submits that the statutory provisions set out in sections 52A Purpose of Part 4 and 52R Purpose of Input Methodologies, are of paramount importance. Section 52V also specifies the process that the Commission must follow when undertaking its review.
31. The ENA recommends that it is most important at this stage to determine a clear framework and process for the review. This is necessary before it is possible to assess which aspects of the IMs should be given the most attention.
32. We suggest that an appropriate process may be one which includes the following key steps:
 - a) Develop a formal process for the review, including key steps, timing and protocols;

- b)* Undertake a landscape review to assess what has changed since the 2010/11 IMs were determined and how have the IMs performed to date;
 - c)* Establish the legal and economic framework for the review; and
 - d)* Undertake technical analysis of potential changes to IMs or new IMs.
33. The ENA also considers that there should be clear expectations about the purpose of the seven year review of IMs, and the circumstances which might lead to other changes in the IMs which may be made in the intervening period.

3. Timing and process

3.1 Proposed timing

34. The Open Letter proposes that:
- a) all of the existing IMs are reviewed at the same time, irrespective of sector or the date they were published; and
 - b) the IM review is completed by December 2016, in order for any changes to be reflected in the DPP price paths for gas suppliers, which are to be reset in 2017 and price setting events for two of the major airports (AIAL and CIAL), which are due in 2017.
35. ENB Default Price-Quality Paths (DPPs) are not due for reset until the end of 2019, along with Transpower's Individual Price-Quality Path (IPP). WIAL's next price setting event is also scheduled for 2019.
36. This proposal effectively accelerates the review ahead of the seven year deadline, which will be January 2018 for the original IMs published in January 2011, and September 2019 for the additional DPP IMs published in September 2012.

3.1.1 Current IM reviews

37. The Open Letter also notes that there are amendments to IMs which are expected to be progressed prior to the IM review, including further amendments to the incremental rolling incentive scheme (IRIS) IM. In our recent submission on the proposed amendments to the IRIS IM², we suggested that due to unresolved issues with the proposals, it is not appropriate to proceed with the proposed amendments at this time.
38. The Commission had also planned to review the customised price-quality path (CPP) IMs following Orion New Zealand's CPP determination in November 2013, however this has not yet occurred, and the timing for that is currently not known. It would be helpful if the Commission was able to clarify whether it intends to proceed with the CPP IM review in advance of the full IM review.

3.1.2 Timing considerations

39. The ENA agrees that it makes sense to review all of the IMs at one time, including those that apply across the electricity, gas and airports sectors. There is sufficient overlap between the IMs for each sector to justify this approach, and accordingly avoid duplicating effort.
40. The ENA also agree that it makes sense to review the complete set of IMs for each sector at the same time, because of the interplay between different elements of each IM. To do otherwise raises the possibility of inconsistency or re work if IMs were reviewed sequentially, which adds unnecessary complexity to the regulatory regime.
41. The Open Letter suggests that one advantage of reviewing the IMs together is that it will align the potential timing of the subsequent section 52Y review. We note however that if the Commission continues to introduce interim amendments, as it has done to date, then the misalignment of publication dates may continue to be a feature of the IMs.

² ENA, Submission on the further amendments to input methodologies for electricity distributors subject to price-quality regulation, Incremental Rolling Incentive Scheme, 20 March 2015

42. The ENA's primary concern is that sufficient time is made available for the review. Assuming all IMs are reviewed at once, then the statutory deadline is January 2018 (ie: seven years from the publication date of the first set of IMs). The proposed deadline reduces this by 13 months.
43. We are not persuaded that it is appropriate to reduce the time available in order to meet other regulatory deadlines. This is not a requirement in the Act. The IMs should provide regulatory certainty, and accordingly be set with the expectation that they are fit for purpose for the regulatory decisions that are made within a seven year period. In practice, this means that those regulatory decisions which rely on the IMs may reach beyond the seven year period.
44. There is no perfect time for the IM review because of the length of the regulatory and pricing periods, and the disjoint between the timing across the sectors. As stated above, our primary concern is that if insufficient time is available to complete the review, the scope of the review and the quality of the analysis and consultation processes may be compromised.

3.2 Consultation considerations

45. The Open Letter does not devote much attention to the proposed consultation process for the IM review. There were useful lessons learned from the initial IM determination process, and additional consultation experience has been gained in the subsequent IM, price-quality path and ID consultations and merits reviews. We trust the Commission will consider how the process may be improved for the forthcoming review.
46. In this respect the ENA makes the following observations:
 - a) There will inevitably be a significant amount of consultation material to be considered and responded to. There needs to be sufficient time to do this. While staggering deadlines helps, overlapping ones are less useful.
 - b) There needs to be a transparent process for how expert evidence is acquired and used throughout the process. This will ensure the most value is gained from the expert input. Possible improvements include agreement on terms of reference and the type of experts to be engaged (eg: academic, commercial, business etc), ensuring expert inputs are available early enough in the consultation process, and the potential for getting experts together to debate agreed issues.
 - c) The earlier that good quality draft determinations are available the better. Substantive changes late in the drafting process are unhelpful.
47. We anticipate providing more comprehensive input into process considerations, at the 'Process and Issues' consultation stage.

3.3 Recommendations

48. In conclusion, the ENA supports the proposal to:
 - a) review all of the IMs at one time, including those that apply across the electricity, gas and airports sectors. There is sufficient overlap between the IMs for each sector to justify this approach, and accordingly avoid duplicating effort; and
 - b) review the complete set of IMs for each sector at the same time, because of the interplay between different elements of each IM. To do otherwise raises the possibility of inconsistency or re work if IMs were reviewed sequentially.
49. There is no perfect time for the IM review because of the length of the regulatory and pricing periods, and the disjoint between the timing across the sectors. The ENA's primary concern is that

if insufficient time is available to complete the review, the scope of the review and the quality of the analysis and consultation processes may be compromised.

50. The ENA also recommends that the lessons learned from previous regulatory decision making processes under Part 4 are fully considered when establishing the process for the IM review, including in relation to timing, use of experts and consultation material.

4. Scope of the review

4.1 Possible topic areas

51. In this section we focus on possible topic areas for review, in the IMs which apply to ENBs. We have not considered the airports IMs or the IMs which apply to gas pipeline businesses, or Transpower.
52. We note that the topics covered in this submission should not be perceived as the only issues which the ENA considers might be addressed during the IM review, and we anticipate contributing more fully to the review as it progresses.
53. The Open Letter indicates that following conversations with interested parties, and the experience to date with the IMs, that the Commission understands potential topic areas for focus include:
 - a) elements of the cost of capital IM, including the Capital Asset Pricing Model (CAPM) and how certain parameters within the CAPM are set;
 - b) the form of control for DPPs and CPPs, including the option of introducing a revenue cap rather than the current price cap form of control;
 - c) the impact of disruptive technologies, including the potential consequences on elements of the asset valuation IM; and
 - d) opportunities to reduce compliance cost and complexity.
54. The following observations are relevant for further consideration in this respect.

4.1.1 IMs are a package

55. The ENA does not consider that each IM should be considered in isolation as they form a suite of methods which together are intended to deliver outcomes consistent with those defined in section 52A.
56. For example, the cost of capital IM must reflect the risks which are inherent in the investments which are required to provide consumers with electricity distribution services. These risks are reflected not only in the cost of capital IM, but also in the other IMs which ultimately determine the revenues ENBs are able to recover, such as asset valuation, the form of control, cost allocation and regulatory tax. Other regulatory rules and processes also contribute to investor risk, such as re-opener provisions, and the processes which specify how DPPs and CPPs are determined.
57. We therefore caution against an approach which focusses solely on discrete aspects of an IM. It will be necessary to step outside the discrete technical debates, and consider the inter-relationships between an IM such as the regulated cost of capital and the wider regulatory framework.

4.1.2 Changing circumstances

58. The recent DPP Determination recognised the changes in energy intensity which have emerged in recent years. These, along with the potential impact of disruptive technologies, and regulatory constraints such as the Low User Fixed Charge Regulations, suggest that consumer demands for electricity distribution services and ENB revenue recovery profiles are changing.
59. While consumers already have supply choices in some instances; notably natural gas and LPG, advances in solar photovoltaics (PV) and battery technology are increasingly making small scale distributed generation (SSDG) a viable alternative supply source. New Zealand has begun to see

increasing uptake of these technologies and ENBs are mindful of the challenges and opportunities these developments are expected to present.

60. At the same time, the sector is now starting to have access to more information on consumer demand; with the recent deployment of smart meters with half-hour, real-time, remote read functionality. Smart meter data allows pricing to be more closely aligned with the costs of providing electricity distribution services. When combined with new market functions and smart appliances, smart meters also have the potential to facilitate greater participation in demand side response, including from businesses traditionally not involved in the sector.
61. Electric Vehicles (EVs) have the potential to offset the energy efficiency trends in electricity consumption. Global production of these vehicles is growing, albeit off a small base, with many major car manufacturers entering the market. Despite this growth potential, uptake of EVs has been slow, with low rates of uptake in New Zealand to date. We note that the capital cost of EVs and the cost of replacing batteries continue to be barriers to EV uptake for most motorists.
62. Accordingly the ENA agrees that technological developments which impact on consumer demand for electricity distribution services and the nature of the services that ENBs provide to their connected consumers are relevant considerations for the IM review. As stated above, we consider these considerations are relevant to the overall suite of IMs, and the scope of regulated services, not just specific components of the asset valuation IM as suggested in the Open Letter.

4.2 Other considerations

4.2.1 DPP and CPP processes

63. In April 2014 we provided comprehensive feedback to the Commission on Orion's CPP process³. We suggested that there was an opportunity to significantly improve the CPP IMs to ensure that they were more cost effective, targeted and to reduce the risks and uncertainties for suppliers inherent in the current CPP processes. We also suggested changes to the pre-application processes to improve the way in which inputs from consumers and independent verifiers are reflected in CPP applications.
64. It is vitally important for the success of Part 4 for ENBs that the DPP/ CPP framework operates effectively. We do not consider that this has yet been achieved. The ENA therefore submits that the IM review should consider how the uncertainties, costs and risks in the CPP process can be reduced. This may include more alignment between the rules and processes which apply to DPPs and CPPs within a regulatory period, and providing a CPP 'light' option which focusses on specific elements in a DPP determination which are not fit for purpose for an individual ENB.
65. As stated earlier in this submission, it is not clear as to whether the Commission plans to proceed with the planned review of the CPP IM in advance of the IM review. We would appreciate clarification in this respect.

³ ENA, Feedback on setting Orion's customised price-quality path, 11 April 2014

4.2.2 Information disclosure IMs

66. When introducing recent amendments to the ID determination⁴, it was decided that amendments which required changes to the IMs would not be considered. The implication was that the appropriate time to address ID issues which have a flow on effect to the IMs, was during the IM review.
67. ID regulation is an important component of the Part 4 regime. It applies to all ENBs, unlike DPP/ CPP regulation. In addition, consistent with the section 53A purpose of ID, it provides an important source of information necessary to assess whether the section 52A purpose of Part 4 is being met, which is directly relevant to the IM review.
68. The amendments which have been made to the 2012 ID determination to date have largely corrected for errors and inconsistencies, addressed unanticipated consequences and reduced ambiguity. In addition, amendments have been made to better align ID with recent developments to the DPP, although there are a number of DPP features which are not yet fully reflected in ID.
69. The ENA notes that some amendments which could have been made to correct for errors and inconsistencies etc, have not been progressed because they require a corresponding correction to the ID IMs. For example there are inconsistencies in the related party transaction rules which apply to opex (which are specified in ID) and capex (which are specified in the IMs).
70. We consider that these amendments should be included in the scope of the IM review, to ensure that the ID is fit for purpose.

4.2.3 IRIS IMs

71. Currently the proposed amendments to the IRIS IMs are incomplete, in particular the opex IRIS rules that will apply when transitioning from a DPP to a CPP. In addition, those aspects of the IRIS IMs which have been amended are currently untested, as they will apply for the first time from 1 April 2015.
72. The IRIS incentive schemes for opex and capex have proven to be easier to design in principle than they have in practice. The DPP/ CPP framework introduces specific challenges for inter regulatory period expenditure incentives.
73. Accordingly, the ENA submits that it may be appropriate to consider whether there is evidence available after 1 April 2015 which suggests improvements could be made to the IRIS IMs during the IM review. These may include, for example:
 - a) whether there are ways to reduce regulatory barriers to mergers, which could enhance the efficiency incentives of the IMs; and
 - b) whether the IRIS mechanisms actually capture and reward efficient behaviour.

4.3 Recommendations

74. We note that the topics covered in this submission should not be perceived as the only issues which the ENA considers might be addressed during the IM review, and we anticipate contributing more fully to the review as it progresses.

⁴ Commerce Commission, 2015 Amendment to the Electricity Distribution Information Disclosure Determination 2012, 24 March 2015

75. The ENA does not consider that each IM should be considered in isolation as they form a suite of methods which together are intended to deliver outcomes consistent with those defined in section 52A.
76. In determining the focus of the IM review, the ENA: agrees that technological developments which impact on consumer demand for electricity distribution services and the nature of the services that ENBs provide to their connected consumers are relevant to the IM review. We consider these issues apply to the overall suite of IMs. In addition to the possible focus areas outlined in the Open Letter, the ENA recommends that the IM review also:
 - a) seeks to improve the way the DPP/CPP framework operates, by reducing the costs and risks which are currently a feature of the CPP option;
 - b) addresses issues in the ID IMs, which have been identified but not yet resolved; and
 - c) considers whether there are opportunities to improve the IRIS IM, which is currently incomplete and largely untested.