

Input methodologies review

Emerging views on opportunities to improve the way default and customised price-quality paths work together

Date of publication: 29 February 2016

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Executive summary

- X1. The purpose of this paper is to:
- X1.1 Share and explain our emerging views on opportunities to improve the way default and customised price-quality paths, including the change mechanisms within them (ie, pass-through costs, recoverable costs, and reopeners), work together to promote the long-term benefit of consumers; and
 - X1.2 Provide you with the opportunity to comment on, and help shape our emerging views in this area, prior to us reaching draft decisions anticipated for mid-June 2016.
- X2. This paper is part of the input methodologies review (**IM review**), and is relevant to electricity distributors and gas pipeline businesses subject to DPP/ CPP regulation under Part 4 of the Commerce Act 1986 (the **Act**). It picks up on topic 8 from the IM review problem definition paper,¹ which focused on exploring opportunities to reduce the cost involved in making and assessing a CPP application.
- X3. There are opportunities to improve the way default and customised price-quality paths, including the path change mechanisms within them (ie, pass-through costs, recoverable costs, and re-openers), work together to promote the long-term benefit of consumers. These opportunities involve changing the current regulatory settings for price-quality paths to enable them to better meet the circumstances of individual suppliers where this can be achieved in a way that remains consistent with the relatively low-cost purpose of DPP/ CPP regulation. This paper provides our emerging views on those opportunities.
- X4. In thinking about the circumstances in which each of the DPP, CPP, and the path change mechanisms within them might best be used, and therefore the design of and implementation of each, we have considered the following factors:
- X4.1. A proposed principle that the level of scrutiny applied should be commensurate with the price and quality impact on consumers of the tailoring being sought, which we term the proportionate scrutiny principle;
 - X4.2. The extent to which the input in respect of which tailoring is sought can be adjusted independently of other inputs;
 - X4.3. The extent to which we have confidence in suppliers' own forecasts, which is likely to be informed by the scrutiny that has already been applied to that information;
 - X4.4. The degree of certainty associated with the timing and/or cost of the project (or other purpose) for which tailoring is sought; and

¹ Commerce Commission "Input methodologies review: Invitation to contribute to problem definition" (16 June 2015).

- X4.5. The number of affected suppliers, which affects the cost of scrutiny.
- X5. In summary, our emerging views are:
- X5.1. Emerging view 1: We are open to taking a more tailored approach to setting the DPP where this can be done without significantly increasing cost;
 - X5.2. Emerging view 2: That 'single-issue' CPPs are not appropriate;
 - X5.3. Emerging view 3: We should apply a proportionate scrutiny principle in continuing to refine the CPP requirements and in assessing CPP proposals;
 - X5.4. Emerging view 4: We are open to expanding the role of DPP reopeners;
 - X5.5. Emerging view 5: The quality-only CPP option should be replaced with a DPP reopener;
 - X5.6. Emerging view 6: We are open to considering a CPP reopener for contingent and unforeseen projects;
 - X5.7. Emerging view 7: We are open to considering approval of costs incurred prior to CPP approval; and
 - X5.8. Emerging view 8: We are open to providing for the expansion of the range of pass-through costs that can be added when setting the DPP.
- X6. We invite comments on this paper by 5pm on 24 March 2016.

Introduction

Purpose of this paper

1. The purpose of this paper is to:
 - 1.1 Share and explain our emerging views on opportunities to improve the way default and customised price-quality paths, including the change mechanisms within them (ie, pass-through costs, recoverable costs, and re-openers²) work together to promote the long-term benefit of consumers; and
 - 1.2 Provide you with the opportunity to comment on, and help shape our emerging views in this area, prior to us reaching draft decisions anticipated for mid-June 2016.
2. Our emerging views are presented at a high-level at this stage—we want to test them with you before developing them further. If following your feedback, we decide to take forward any of the emerging views expressed in this paper to our draft decisions, we will flesh out the detail on how they might be implemented at that stage.³ As such, we are interested in your feedback on whether you agree with our emerging views in principle as well as any feedback on how we might implement them.
3. This paper is relevant to electricity distributors and gas pipeline businesses subject to DPP/ CPP regulation under Part 4 of the Act.

Structure of this paper

4. This paper is divided into the following chapters:
 - 4.1 The first chapter sets out the context for this work, including where it fits within the IM review, notes other complementary work, and notes the legislative context. It also sets out our problem definition for this paper.
 - 4.2 The second chapter presents our eight emerging views in response to the problem definition. It also describes the conceptual approach that led to our emerging views.
 - 4.3 The third and final chapter provides a real-world example that illustrates how a number of our emerging views might apply in practice.
5. The attachment to this paper summarises our analysis on the statutory, current, and proposed characteristics of the DPP, CPP, and the path change mechanisms within them.

² We use the term reopener in this paper in reference to the circumstances in which price-quality paths may be reconsidered within a regulatory period, as set out in the IMs.

³ For example, the trigger criteria relating to any new DPP re-openers.

Invitation to comment

6. We invite comments on this paper by 5pm on 24 March 2016.

7. Please address comments to:

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Problem definition and context

8. This chapter introduces the problem that this paper is focused on. It also explains the context for the problem definition and our emerging views.

Where this paper sits within the IM review

9. This paper picks up on topic 8 from the problem definition paper,⁴ which was focused on exploring opportunities to reduce the cost involved in making and assessing a CPP application. That topic chapter noted a range of options for reducing the cost of better tailoring the price-quality path, including considering:
 - 9.1 Opportunities to reduce the CPP application and assessment requirements, where this could be achieved without compromising our ability to appropriately assess the application; and
 - 9.2 Introducing 'single-issue' CPPs, which would be reduced in scope compared to a regular CPP where customisation is only sought in respect of part of the supplier's DPP.
10. Having considered this further, and having had the benefit of submissions on this topic, we have reached the view that it is beneficial to step back and consider the range of options that currently exist for tailoring default/customised price-quality paths, and their effectiveness, before considering new mechanisms, such as single-issue CPPs. The focus of this paper is therefore on opportunities to improve the way default and customised price-quality paths, including the path change mechanisms within them (ie, pass-through costs, recoverable costs, and re-openers), work together to promote the long-term benefit of consumers. As noted in topic 8 of the problem definition paper,⁵ given the purpose of default/customised price-quality regulation,⁶ "[w]e should therefore consider CPP regulation as a complement to DPP regulation, and not consider it in isolation."
11. To this end, this paper considers:
 - 11.1 The options available within the current regulatory settings for tailoring the price path. These current options include flexibility in how we set the DPP, the current range of specified pass-through and recoverable cost provisions (under DPPs and CPPs), the current reopener provisions (under DPPs and CPPs), and the CPP and quality-only CPP options; and

⁴ Commerce Commission "Input methodologies review: Invitation to contribute to problem definition" (16 June 2015).

⁵ Ibid, para 409.

⁶ As per s 53K of the Commerce Act 1986 (the **Act**), "The purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances."

- 11.2 Whether we should make changes to the design or application of the current options to better enable tailoring of the price-quality path where it would better promote the long-term benefit of consumers. We present our emerging views on this.

Complementary work

12. In addition to the emerging views described in this paper, there are other opportunities both within and outside of the IM review to better enable, or promote, tailoring of the price-quality path in circumstances where better tailoring is in the long-term interests of consumers.

Complementary work within the IM review

13. On 12 November 2015 we published a final decision on the CPP fast track amendments as part of the IM review.⁷ These IM amendments were aimed at improving the cost-effectiveness of preparation, assessment and determination of CPP applications by:
- 13.1 Introducing flexibility for suppliers by allowing:
 - 13.1.1 Modifications or exemptions to the process for preparing, and content of, CPP proposals; and
 - 13.1.2 The use of alternative methodologies with equivalent effect (AMWEEs) for certain elements of CPP proposals.
 - 13.2 Allowing us to accept CPP applications for consideration if they comply with the process and content IMs “in all material respects”.
14. As part of our draft decisions on the IM review anticipated for mid-June 2016, we also intend to reach a draft decision on how to address the potential for perverse incentives to arise when there is a difference between the weighted average cost of capital (WACC) under a DPP and a CPP.⁸

⁷ Electricity and Gas (Customised Paths) Input Methodology Amendments Determination 2015 [2015] NZCC 28.

⁸ This work relates to the issues discussed in topic 3 of the problem definition paper: Commerce Commission “Input methodologies review: Invitation to contribute to problem definition” (16 June 2015). On 9 October we decided not to continue to progress this in the fast track, deciding instead to consider it in the main input methodologies review. See: Commerce Commission “Input methodologies review process update paper: Second update on CPP fast track amendments” (9 October 2015).

15. In addition to the fast track amendments described above, we are also continuing to progress the work we are doing to make compliance with the CPP requirements IMs more cost-effective for suppliers in a manner consistent with providing long-term benefits to consumers. We intend to host a workshop to discuss, in detail, potential revisions to the CPP information requirements for EDBs in mid-April 2016.⁹

Complementary work outside of the IM review

16. The current IM review is not the only opportunity to promote and better enable tailoring of the price-quality path where it is in the long-term interests of consumers.
17. There are also opportunities for us to pursue this objective outside of the IM review, including through:
- 17.1 Clarifying for suppliers the opportunities for tailoring provided by the CPP option and other available tailoring mechanisms;
 - 17.2 Building on the lessons learned during the Orion CPP process, and improving our internal process for the next CPP application we receive; and
 - 17.3 Improving our engagement with prospective CPP applicants.
18. However, the focus of this paper, within the context of IM review, is on whether we can make any changes to the IMs that would improve the ability of the DPPs, CPPs and the change mechanisms within them to enable tailoring of the price-quality path where it is in the long-term interests of consumers.

Legislative context

19. Our design and implementation of the DPP and CPP (including the path change mechanisms within them) should promote the Part 4 purpose,¹⁰ in light of the purpose of DPP/ CPP regulation.¹¹ It should, as a whole and in conjunction with the other aspects of the regulatory regime, do this by providing incentives for suppliers to act in a manner consistent with the Part 4 purpose. Our design and implementation of the DPP and CPP should provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.

⁹ The aim of the workshop will be to discuss potential revisions to the information requirements for CPPs to help address some of the cost/complexity concerns highlighted by interested parties in relation to the EDB input methodologies, in particular Schedules D and E. We expect to publish workshop materials for review .

¹⁰ Commerce Act 1986, s 52A.

¹¹ Commerce Act 1986, s 53K.

20. In order to best promote s 52A, in light of s 53K, our design and implementation of the DPP and CPP should be tailored to accommodate suppliers' circumstances at a level of cost and scrutiny that is proportionate and commensurate with the intent of the DPP/CPP regime, and the individual path change mechanisms within it. We consider that 'scrutiny' includes the scope and specificity of information requirements, verification and audit requirements, consumer consultation expectations, and our evaluation criteria. While the IMs explicitly set out these requirements for a CPP application, these are also potentially relevant explicit or implicit dimensions when tailoring the DPP and path change mechanisms. In the next chapter, at paragraphs 30 and 31, we expand on how better tailoring can better promote long-term benefits for consumers.
21. Promoting the long-term benefit of consumers in this context therefore involves striking the right balance of scrutiny in our design and implementation of the DPP, CPP, and the path change mechanisms within them. This is because:
- 21.1 Greater scrutiny can impose higher costs on both us and regulated suppliers, which can ultimately be passed on to consumers; but
 - 21.2 Greater scrutiny can also benefit consumers by ensuring that regulated suppliers deliver prices that are more commensurate with the level of quality demanded.
22. This recognition of the costs and benefits of scrutiny, together with our experience of having now set a CPP and set and reset DPPs, inform the proportionate scrutiny principle that we propose at paragraph 35 of this paper, which is about applying a level of scrutiny when tailoring the price-quality path that is commensurate with the price and quality impact of the tailoring on consumers.
23. Within the bounds of the requirements of the Act, we have discretion about how we set the DPP and CPP, and the path change mechanisms within them. Attachment A summarises some of the key statutory characteristics of the DPP, CPP and path change mechanisms.

Problem definition for this paper

24. In light of the context described above, the problem definition that this paper addresses is set out on the following page.

25. There are opportunities to improve the way default and customised price-quality paths, including the path change mechanisms within them (ie, pass-through costs, recoverable costs, and re-openers), work together to promote the long-term benefit of consumers. These opportunities involve changing aspects of the current regulatory settings for price-quality paths to enable them to better meet the circumstances of individual suppliers where this can be achieved in a way that remains consistent with the relatively low-cost purpose of DPP/ CPP regulation. There are broadly three situations where amending the application and/or design of DPPs, CPPs and path change mechanisms may better promote the long-term benefit of consumers:
- 25.1 During the setting of the DPP, where the supplier's circumstances can be accommodated upfront in a relatively low-cost way;
 - 25.2 At the beginning of the regulatory period, if once set, the DPP could be changed to better meet the supplier's individual circumstances in a relatively low-cost way; or
 - 25.3 During the DPP or CPP regulatory period, if circumstances materially change during the regulatory period from the circumstances that were assumed when the DPP or CPP was set.

Our emerging views

26. This chapter presents our emerging views on how we might improve the way default and customised price-quality paths, including the path change mechanisms within them, work together to promote the long-term benefit of consumers.
27. In reaching our emerging views:
- 27.1 We considered the mechanisms that are currently available for tailoring the price path. These include:
- 27.1.1 How we set the DPP;
- 27.1.2 The pass-through and recoverable cost provisions under DPPs and CPPs;
- 27.1.3 The DPP and CPP reopener provisions;
- 27.1.4 The single-issue CPP option (available for quality-only); and
- 27.1.5 The CPP.
- 27.2 In respect of each of these tailoring mechanisms, we first considered:
- 27.2.1 What are the key fixed (ie, statutory) characteristics of this mechanism?
- 27.2.2 What are the key current settings in respect of this mechanism (ie, characteristics set in the IMs, s 52P determinations, or in our current practices)?
- 27.3 We then considered whether we should make changes to the design or application of the current mechanisms to better enable tailoring of the price-quality path where it would better promote the long-term benefit of consumers.
28. Attachment A presents a summary of this analysis. The remainder of this chapter explains our emerging views, but first we explain the conceptual approach that led to our emerging views.

The conceptual approach that led to our emerging views

Why better enable tailoring of the price-quality path?

29. In order to best promote the long-term benefit of consumers, the configuration of the DPP, CPP, and the path change mechanisms within them, should accommodate suppliers' circumstances at a level of cost and scrutiny that is commensurate with price and quality impact on consumers and consistent with the purpose of the DPP/ CPP regime (including the individual mechanisms within it).

30. Providing tailoring opportunities to take greater account of suppliers' specific circumstances at a proportionate level of scrutiny and cost¹² enables tailoring of the price-quality path where such tailoring is in the long-term interests of consumers. Greater tailoring can better promote the long-term benefit of consumers where it ensures that the price-quality path provides for efficient investment and rewards superior performance with greater profits, but not to the point that those profits are excessive.¹³ For example, by tailoring a price path to take great account of a supplier's specific circumstances, we can incentivise expenditure or investment needed to maintain quality to a level that consumers demand or an efficient capex project that promotes the long-term benefits of consumers. As noted above, however, tailoring also involves scrutiny and therefore cost—which must also be taken into account.
31. There are a limited number of variables within the price-quality path that, if not set or forecast appropriately, may cause the price path to be set, or become, unsuitable for a supplier in a way that does not best promote the long-term benefit of consumers. These include: capex, opex, reliability limits, demand/constant-price-revenue-growth (CPRG), and incentive rates.
32. There are potentially a very large number of real-world scenarios that could give rise to a situation where better tailoring would promote the long-term interests of consumers, but each of these will impact on one or more of the variables within the path. In the next chapter, we consider how our proposed changes might improve the ability of the DPP/CPP to enable tailoring in some real-world scenarios.

Our approach to determining the appropriate settings for each tailoring mechanism and the relevant factors we consider

33. The first opportunity to tailor the price-quality path to a supplier's specific circumstances is when we set the DPP. In deciding on the level of supplier specific tailoring that is appropriate in setting the DPP we are guided by the 'relatively low-cost' statutory purpose of DPP/CPP regulation.
34. The CPP on the other hand, is a price-quality path that is fully tailored to the supplier's circumstances. The Act also provides for other path change mechanisms, such as pass-through/recoverable costs and reopeners, which are in place for both DPPs and CPPs.

¹² See paragraph 21 above.

¹³ In terms of s 52A(1) of the Act, this includes balancing limb (a) which is about providing incentives for suppliers to "innovate and to invest, including in replacement, upgraded, and new assets" and limb (d) which is about limiting the ability of suppliers to "extract excessive profits".

35. As outlined at paragraph 21, scrutiny generally involves time and cost. As such, we propose that a guiding principle for designing, implementing and applying tailoring mechanisms should therefore be that the level of scrutiny applied should be commensurate with the price and quality impact on consumers of the tailoring being sought (**proportionate scrutiny principle**). Achieving this requires setting each of the DPP, CPP, and the path change mechanisms in a way that provides a range of tailoring options, each with varying levels of scrutiny and cost.
36. In thinking about the circumstances in which each tailoring mechanism might best be used, and the design of each mechanism, we have considered the following factors:
- 36.1 The proportionate scrutiny principle;
 - 36.2 The extent to which the input in respect of which tailoring is sought can be adjusted independently of other inputs;
 - 36.3 The extent to which we have confidence in suppliers' own forecasts, which is likely to be informed by the scrutiny that has already been applied, by the Commission or interested parties, to that information:
 - 36.3.1 In setting the DPP;
 - 36.3.2 Under the information disclosure regime (eg, of asset management plans) or via the Commission's summary and analysis in recent years;
 - 36.4 The degree of certainty associated with the timing and/or cost of the project (or other purpose) for which tailoring is sought; and
 - 36.5 The number of affected suppliers, which affects the cost of scrutiny.

Emerging view 1: We are open to taking a more tailored approach to setting the DPP where this can be done without significantly increasing cost

37. We are open to opportunities to take a more tailored approach to setting the DPP where this can be done without significantly increasing cost. The extent to which we are able to do so will be influenced by:
- 37.1 The number of affected suppliers, which affects the cost of scrutiny; and
 - 37.2 The degree of certainty associated with the timing and/or cost of the project (or other purpose) for which tailoring is sought.

The number of affected suppliers

38. In the shorter term, taking a more tailored approach to setting the DPP without significantly increasing cost is more likely to be achievable for gas pipeline businesses than for electricity distributors. This is due to the relatively large number of electricity distributors as compared to the number of gas pipeline businesses.

39. Whether we can take a more tailored approach to setting the DPP without significantly increasing cost is something we are keen to explore as part of the upcoming DPP reset for gas pipeline businesses.¹⁴
40. For electricity, a more tailored approach to the DPP might evolve over time as we learn more from our summary and analysis of information disclosed under the information disclosure regime, and therefore gain more confidence in the recent forecasts of some or all suppliers.

The degree of certainty of timing and cost of the project for which tailoring is sought

41. The degree of certainty associated with the timing and/or cost of the project (or other purpose) for which tailoring is sought will also influence whether we tailor the DPP to accommodate the project. To the extent that the cost and timing of the expenditure is:
 - 41.1 Relatively certain, and not a substantial step change from past expenditure, we could look to accommodate it in setting the DPP;
 - 41.2 Not certain, or a substantial step change from past expenditure, tailoring the price-quality path to accommodate this expenditure would require a CPP. Our emerging views in respect to the scope and depth of scrutiny we apply to CPP proposals are discussed below.

Emerging view 2: We consider that ‘single-issue’ CPPs are not appropriate

42. We consider that ‘single-issue’ CPPs are not appropriate. Rather, for the reasons set out in the next paragraph, our emerging view is that CPPs should always be full scope. By ‘full scope’, we mean that the scope of the application will encompass all inputs needed to set the price-quality path. This means that all inputs are potentially subject to scrutiny. However, as noted above, the depth of scrutiny we apply to different aspects of the application may differ according to the proportionate scrutiny principle and our level of confidence in the supplier’s own forecasts. This may mean that our evaluation of some inputs may be limited or not required.

¹⁴ For example, one area where it may be appropriate to consider applying a more tailored approach to setting a DPP is for the GDB expenditure forecasts. Given there are only small number of gas suppliers it may be consistent with low-cost forecasting principles to assess each suppliers’ AMP forecasts, gaining assurance through working groups, or external review. In particular, given recent changes of business ownership in the sector, there might be only one regulated gas transmission business. See Commerce Commission “Default price-quality paths for gas pipeline businesses from 1 October 2017 – Proposed process and issues we are considering” (29 February 2016).

43. We see a number of issues with single-issue CPPs:
- 43.1 *Period alignment:* When we set a CPP, we must set the full price-quality path, for a period of 3 to 5 years, and it is therefore likely to extend past the current DPP period.¹⁵ If we were relying on DPP forecasts to complete the path for the aspects of the path not subject to the CPP proposal, this information will only be available to the end of the DPP period. We would always need to forecast all inputs of the path beyond the DPP period where a single-issue CPP was sought in the last 3 years of a DPP period, which is beyond the scope of a single-issue CPP.
 - 43.2 *Asymmetry between suppliers and consumers:* Suppliers are likely to only customise elements of a DPP that are not favourable to them. This creates an asymmetry in that no other party is able to apply for a CPP in a situation where the DPP might provide for an overly favourable input to a supplier. As such, providing for single-issue CPPs risks tipping the balance in the DPP/CPP regime in favour of suppliers and not promoting the long-term benefit of consumers.
 - 43.3 *Interdependencies:* For many inputs, it will be inappropriate to customise them in isolation as they have interdependencies with other parts of the path. For example, price, capex, opex and quality are generally strongly linked, which makes each difficult to adjust in isolation. On the other hand, as discussed further in emerging views 4 and 5, in some circumstances the quality standards and CPRG could be adjusted independently of other inputs to the DPP.
 - 43.4 *Uses up a supplier's one CPP opportunity for the period:* For those inputs that are able to be changed independently from the rest of the path, a significant downside of a single-issue CPP would be that it uses up the supplier's one opportunity to apply for a CPP in the underlying DPP regulatory period.¹⁶ For this reason, a DPP reopener may be a better solution for such circumstances, especially for changed circumstances that affect multiple suppliers.
44. The only single-issue CPP currently provided for is for customising the quality standards. As discussed under emerging view 5 below, we consider that the quality-only CPP could be replaced with a new DPP reopener provision.

¹⁵ Commerce Act 1986, s 53W.

¹⁶ Commerce Act 1986, s 53Q(3).

Emerging view 3: We should apply a proportionate scrutiny principle in continuing to refine the CPP requirements and in assessing CPP proposals

45. We consider that all CPPs should be full scope (as discussed under emerging view 2). However, we consider that there is an opportunity for us to be more targeted in the depth of scrutiny we apply to different inputs when assessing a CPP proposal informed by:
- 45.1 The proportionate scrutiny principle; and
 - 45.2 The extent to which we have confidence in the supplier's own forecasts.¹⁷
46. Already as part of the IM review, we have introduced exemption and modification provisions, which allows us to require less or different information from a supplier in respect of a CPP application, consistent with the proportionate scrutiny principle.
47. The proportionate scrutiny principle will also guide our continuing work, as part of the IM review, to make changes to reduce unnecessary cost and complexity in the CPP requirements. This will include as part of our draft decisions:
- 47.1 Making improvements to the scope and specificity of the information requirements for CPPs;
 - 47.2 Clarifying the roles of the independent verifier, auditor and independent engineer; and
 - 47.3 Clarifying our consumer consultation expectations.

Emerging view 4: We are open to expanding the role of DPP reopeners

48. In light of submissions¹⁸ suggesting we might expand the range of circumstances in which we make DPP reopeners available,¹⁹ we have considered what we think DPP reopeners are best used for. Our emerging view is that relevant factors in determining what circumstances a DPP reopener is appropriate for are:
- 48.1 Where an appropriate level of scrutiny can be applied in a relatively low-cost way. The cost of any additional tailoring provided for under a reopener must be achievable at a relatively low-cost, consistent with the role of the DPP;

¹⁷ Our level of confidence in each input will depend on the extent to which that input has already been scrutinised under the DPP or summary and analysis. For example, if a supplier is seeking a CPP to accommodate a large, one-off, item of project expenditure, it might be that we are able to apply a lower level of scrutiny to business-as-usual expenditure, and largely focus on the increment being sought.

¹⁸ For example, see submissions from PwC, Electricity Networks Association and Wellington Electricity, on Commerce Commission "Input methodologies review: Invitation to contribute to problem definition" (16 June 2015).

¹⁹ DPP reopeners are currently available for a fairly narrow range of circumstances. These are for responding to: catastrophic events; regulatory or legislative changes; or where we have made a material error or relied on misleading information in setting the price path. See, for example: *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, subpart 4.5.

- 48.2 Where tailoring is sought in respect of just one input to the price-quality path, and that input is able to be isolated and tailored independently of other inputs to the price-quality path. (As opposed to where the input in respect of which tailoring is sought is interdependent with other inputs to the path, in which case we would need to scrutinise again that part of the path that is already set—but even then it may be problematic to identify the nature and extent of those interdependencies);
- 48.3 Where the tailoring would have a relatively low price and/or quality impact on consumers. Otherwise, it is unlikely that the DPP reopener can provide the appropriate level of scrutiny. Tailoring involving large potential impacts on consumers will be more appropriately dealt with under a CPP;
- 48.4 Where we were unable to take relevant information into account in setting the DPP due to time/resource constraints or prioritisation, or because the information came to light too late in the process. This would only apply to information that we would have considered in setting the DPP had time and resources allowed.²⁰ In these circumstances, it may be appropriate to allow the business specific issue to be considered through a reopener provision; and
- 48.5 Where tailoring is sought in respect of multiple (ie, more than four) suppliers. This is because s 53Z and s 53K of the Act (together and separately) imply that CPPs are not designed to be used to respond to events affecting a large number of suppliers.²¹
49. For circumstances where the above factors are not present, it is likely that the CPP will be the more appropriate option.

Aspects of the default price-quality path that might be suitable for a new reopener provision

50. In addition to the existing DPP reopener provisions, we have only identified two aspects of the DPP that might fit the characteristics listed above based on the way we currently set the DPP:²²

²⁰ Our preference would always be to take account of all relevant information in setting the DPP in first place.

²¹ The High Court directed, in upholding Vector's merits appeal, that the DPP, like the CPP, should include reopener provisions so that a DPP could be reconsidered where a catastrophic or change event occurs. Prior to the Court's decision, we had indicated that, in the absence of a DPP reopener, if a change event or catastrophic event occurred, we would consider CPPs for all affected suppliers—notwithstanding that s 53Z allows us to only consider four applications per year. See *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC [11 December 2013], para 1902–1910.

²² Recent transactions in the gas sector raise the possibility that a DDP or CPP reopener might be an appropriate way to deal with unforeseen aspects of major transactions. We are open to exploring this as an option in circumstances where the reopener would not materially change the effect of any existing price-quality path.

- 50.1 The CPRG forecast, where the relevant form of control is a price cap rather than a revenue cap;²³ and
 - 50.2 The quality standards are set based on historical reliability performance, and independently of forecast expenditure.
51. Our view is that, if we were to allow a DPP reopener for CPRG, it would, at a minimum, only be available to the supplier and the Commission:
- 51.1 For a short period after the DPP is set (because under a price cap it is intended that the demand risk is borne by suppliers); and
 - 51.2 On an exceptional basis, with clear and narrow criteria for triggering the reopener provision. It would not be an opportunity for businesses to ask us to reconsider information that we had already considered in setting the DPP. Nor would it be an opportunity for us to reconsider the DPP on the basis of the same information we considered at the time we set the DPP.
52. Based on the factors outlined at paragraph 48 above, we consider that changes to the quality standards may be a suitable area for a DPP reopener. We discuss our emerging view on this further below.

Other relevant factors in deciding whether to expand the role of reopeners

53. Other relevant factors in considering whether to expand the role of reopeners, are:
- 53.1 Whether it creates an asymmetric risk/opportunity in favour of suppliers;
 - 53.2 That we bear the costs of considering reopener applications, which would ultimately be borne by all consumers of the regulated service (as opposed to only consumers of the supplier to which the reopener relates). This could be significant if we received a large number of reopener applications; and
 - 53.3 Whether providing for additional reopener provisions would promote or compromise predictability for suppliers and consumers.
54. The risk that adding new reopener provisions creates an asymmetric risk/opportunity in favour of suppliers could be mitigated to an extent by implementing the reopener provisions in a way that:
- 54.1 Provides well-defined, narrow trigger events that only provide for exceptional circumstances, as noted at paragraph 51.2;

²³ We have published our emerging views on the form of control on the same date as this paper. See Commerce Commission “IM review: Emerging views on form of control” (29 February 2016). In summary, our emerging views on form of control are that a pure revenue cap should apply for electricity distributors and gas transmission businesses and we have not yet reached a view on the form of control for gas distribution businesses.

- 54.2 Allows us to initiate, as well as the relevant supplier to apply for, a reopener where the trigger event occurs; and
- 54.3 Allows for our decision on the outcome of the reopener to be favourable or unfavourable for the supplier – ie, it would not be a ‘one-way’ bet.²⁴ As such, the price path and/or quality standards could be higher or lower as a result of a reopener.
55. Because the outcome of a reopener could be favourable or unfavourable to the supplier, this should mean that suppliers would be incentivised to only make applications for reopeners where they consider they have a strong case for a favourable outcome. This, along with narrow trigger events, mitigates, to an extent, the risk that we might receive a significant number of reopener applications.
56. As noted above, we should also consider whether adding new reopeners promotes or compromises predictability for suppliers and consumers. Here, again, it is relevant to note that we consider any new reopener provisions would need to have well-defined, narrow trigger events.

We are interested in your views

57. In respect of emerging view 4, we are particularly interested in your views on whether new reopeners could be implemented in a way that appropriately deals with the factors listed at paragraph 54, and if so:
- 57.1 Whether you agree that CPRG and the quality standards are the only inputs that might lend themselves to a reopener based on the factors listed at paragraph 48;
- 57.2 How we should define the trigger events for any new reopeners; and
- 57.3 Whether we should prescribe an application window for reopeners after the DPP is set, and if so, what length should it be?

Emerging view 5: The quality-only CPP option should be replaced with a DPP reopener

58. The IMs currently provide for a single-issue CPP for EDBs seeking only to customise their quality standards.²⁵ If retained, this mechanism would at the very least need to be considered for amendment to reflect the introduction of the revenue-linked quality incentive mechanism for electricity distributors.²⁶

²⁴ As is the case with CPP decisions (s 53V(2) of the Commerce Act 1986).

²⁵ This could become relevant to gas pipeline business if we decide to change the quality standards for gas pipeline business to performance-based standards. See Commerce Commission “Default price-quality paths for gas pipeline businesses from 1 October 2017 – Proposed process and issues we are considering” (29 February 2016).

²⁶ The revenue-linked quality incentive mechanism was introduced for electricity distributors as part of the 2015 DPP reset.

59. Rather than amend the quality-only CPP, our view is that a better option is to replace it with a new DPP reopener provision. Such a reopener would likely be consistent with the factors outlined at paragraph 48 above in which we think a reopener might be appropriate. In particular:
- 59.1 Although price, expenditure and quality are strongly linked, quality can potentially be tailored independently of other variables, particularly once a DPP is set, because we currently set quality standards based on historical performance. Doing so would require holding all inputs other than quality standards constant (including, most relevantly, forecast expenditure) and deciding what level of quality standards would be realistically achievable based on the other existing inputs to the price path; and
 - 59.2 Having it as a reopener instead of a single-issue CPP would allow a supplier to preserve their one opportunity to seek a CPP in the underlying DPP regulatory period.
60. Such a reopener provision would allow tailoring of the quality standards for a supplier during the DPP period where:
- 60.1 The supplier or the Commission demonstrates that an alternative quality standard could better reflect the realistically achievable performance of the EDB over the DPP period, given the expenditure forecasts already provided for in the DPP. For example, where the quality standards we set do not allow the supplier to carry out reasonable network maintenance because we set them based on historical quality performance during a period that was not reflective of the long-term trend;²⁷ and
 - 60.2 The quality standards can be tailored independently of other aspects of the DPP.
61. If adopted, we consider that the implementation of such a reopener should allow:
- 61.1 Us to initiate, as well as the relevant supplier to apply for, a reopener where the trigger event occurs; and
 - 61.2 For our decision on the outcome of the reopener to be favourable or unfavourable for the supplier – ie, it would not be a ‘one-way’ bet.
62. These features would help to mitigate the risk of creating an asymmetry in favour of suppliers over consumers, as discussed above at paragraph 53.

²⁷ That is, such a reopener would not be available in circumstances where a supplier is unable to meet the quality standards due to poor asset management practices. Rather, it is intended to fulfil the same function of the current quality-only CPP.

Emerging view 6: We are open to considering a CPP reopener for contingent and unforeseen projects

63. The IMs for gas transmission currently provide for a CPP reopener for contingent and unforeseen projects.²⁸ This allows the customised path to be reopened to build in incremental expenditure for major projects which were not foreseeable at the time the CPP was set, or which were foreseeable, but the timing, scope or cost of the project was uncertain at the time the CPP was set. Where the underlying expenditure forecasts have been scrutinised under a CPP, we acknowledge that it may be appropriate to add incremental expenditure to the path, while only scrutinising that increment, in some circumstances.
64. We are open to considering if contingent and unforeseen projects might be useful mechanisms to provide for suppliers subject to a CPP, other than gas transmission businesses.²⁹

Emerging view 7: We are open to considering approval of net additional costs incurred prior to CPP approval

65. Colonial First State has suggested that where a project needs to be started urgently, and the expenditure has not yet been included in a CPP proposal that has been approved by the Commission, we should exercise flexibility in applying ex-post approval to allow recovery of expenditure incurred prior to approval being granted.³⁰
66. We are open to considering ways in which additional net costs (over and above those provided for in a DPP determination) prudently incurred in response to an urgent project after a CPP has been submitted but prior to the beginning of the CPP period, can be recovered during a CPP period – and the circumstances where that would be appropriate. In providing for the most recent DPP reset for EDBs we provided for the ex-post recovery of certain costs that are prudently incurred by an EDB in responding to a catastrophic event between the catastrophic event and a DPP reopener or CPP, with Commission approval.³¹

²⁸ *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28, clauses 5.7.3 and 5.7.4.

²⁹ While we have not yet reached a decision on the DPP/CPP WACC alignment issue (see para 14), in the event we decided to align the DPP and CPP WACC values, one way to give effect to the new DPP WACC during the CPP regulatory period would be through a CPP reopener. If we decide to align the DPP and CPP WACC, we are open to considering this option.

³⁰ Colonial First State, submission in response to IM review gas stakeholder forum workshop held on 8 December 2015 (28 January 2016). Note, this was raised in relation to a proposed major capex approval process under a DPP, though we consider that, given our emerging views on DPP reopeners, the issue is more relevant where a urgent project arises and a supplier subsequently applies for a CPP or a CPP reopener.

³¹ *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 3.1.3(1)(n). This clause was added in the 2014 see: Commerce Commission “Input methodology amendments for electricity distribution services: Default price-quality paths” (27 November 2014).

Emerging view 8: We are open to providing for the expansion of the range of pass-through costs that can be added when setting the DPP

67. We currently allow a range of costs to be passed through to prices for DPPs and CPPs. We have put these costs into two categories: ‘pass-through costs’ and ‘recoverable costs’. The main distinction between these two categories is the extent to which they are controllable by the supplier:³²
- 67.1 Pass-through costs are those costs that are regarded as outside the control of the supplier and are suitable to be passed through to consumers without any scrutiny by the Commission.
- 67.2 Recoverable costs, however, are not completely outside the control of the supplier and there may be some judgement involved as to the quantum or nature of the cost to be passed through. In some cases, we have required the costs to be subject to an approval process before they can be passed through.
68. The current IMs also provide the opportunity for us to specify new pass-through costs during a regulatory period in circumstances where a levy or other cost meets the criteria for a pass-through cost, set out in the IMs (**criteria-based pass-through costs**).³³ This is given effect through an amendment to a DPP determination or a CPP determination.³⁴
69. We have not applied the provisions to date, and have not identified any specific types of costs that might be appropriate to treat as a pass-through costs (other than those already explicitly specified as pass-through costs in the IMs).
70. However, on reflection, it seems reasonable that criteria-based pass-through costs, which can currently only be specified *during* the regulatory period, should also be able to be specified in a DPP or CPP determination *at the time the DPP or CPP is set*.
71. Currently, only *levies* that meet the pass-through cost criteria may be added via an amendment to a DPP determination. However, the current IMs allow any costs that meet the pass-through cost criteria to be added via a CPP determination.³⁵
72. We are interested in stakeholders views on the pros and cons of:

³² We have also used recoverable costs to give effect to certain incentive mechanisms.

³³ This criteria is set out in the IMs:

Electricity Distribution Services Input Methodologies Determination 2012 [2012] NZCC 26, clause 3.1.2(3).

Gas Transmission Services Input Methodologies Determination 2012 [2012] NZCC 28, clause 3.1.2(3).

Gas Distribution Services Input Methodologies Determination 2012 [2012] NZCC 27, clause 3.1.2(3)

³⁴ In essence, these provisions operate as reopener provisions, implicitly giving us the ability to amend a determination to add new pass-through costs. However, unlike a reopener where the quantitative changes to the path are scrutinised and made in advance, these provisions allow us to add a new pass-through cost, where the amounts concerned may be automatically passed through.

³⁵ For example, *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 3.1.2(1)(b).

- 72.1 Changing the timing at which new pass-through costs can be added by specification in a DPP or CPP determination; and
- 72.2 Allowing *any* cost, that meets the pass-through cost criteria in the IMs, to be specified as a pass through cost in a DPP Determination, rather than just levies.

A real-world example to illustrate the application of our emerging views

73. In this section we work through an example that demonstrates how our emerging views might apply in practice. We consider the scenarios put forward by Maui and Colonial First State to be good examples to illustrate how a number of our emerging views might apply.³⁶
74. Maui and Colonial First State submitted the following situations are not currently accommodated by the DPP (or any of the path change mechanisms within the DPP), but that they should be (ie, they should not require a CPP):
- 74.1 Planned expenditure where the cost and timing is relatively certain but represents a step change from historical expenditure levels (or is likely to occur at intervals greater than the five-year regulatory period). An example of such a project noted by Maui is pipeline pigging.³⁷
- 74.2 Major projects that are relatively certain to happen but where the timing and cost is still uncertain. An example of such a project noted in Colonial First State's submission is the Whitecliffs project, which would involve the relocation of sections of the transmission pipeline from an area of land instability.³⁸
75. We go on to assess how each of the above might be dealt with under our emerging views.

Planned expenditure where the cost and timing is relatively certain but represents a step change from historical expenditure levels

76. In this situation, to the extent that the cost and timing of the expenditure is relatively certain, we would look to accommodate it in setting the DPP. This reflects that we are open to taking a more tailored approach to setting the DPP where this can be achieved without a significant increase in cost (per emerging view 1). This may be possible in the case of a gas transmission pigging project given the relatively small number of gas pipeline businesses.

³⁶ Maui Development Limited, submission in response to IM review gas stakeholder forum workshop held on 8 December 2015 (28 January 2016); Colonial First State, submission in response to IM review gas stakeholder forum workshop held on 8 December 2015 (28 January 2016).

³⁷ Maui Development Limited, submission in response to IM review gas stakeholder forum workshop held on 8 December 2015 (28 January 2016), p. 4. Pipeline pigging is the internal inspection of pipeline condition and identification of potential faults.

³⁸ Colonial First State, submission in response to IM review gas stakeholder forum workshop held on 8 December 2015 (28 January 2016), p. 5.

77. However, to the extent that the cost and timing of the expenditure is not sufficiently certain, tailoring the price-quality path to accommodate this expenditure would require a CPP. The CPP would be full scope, but the depth of scrutiny we apply would vary across the CPP proposal in light of (per emerging views 2 and 3):
- 77.1 The proportionate scrutiny principle; and
 - 77.2 The extent to which we already have confidence in the supplier's own forecasts.
78. In assessing such a CPP proposal, we would focus our scrutiny on those aspects of the proposal that would be likely to have the biggest price and quality impact on consumers, and those areas where we have a lower degree of confidence in the supplier's forecasts. This is likely to result in the focus of our scrutiny being on the incremental change being sought.³⁹
79. We do not consider that a DPP reopener is an appropriate mechanism for accommodating material increases in expenditure during the regulatory period because of the likely interdependencies with other expenditure and also other aspects of the price-quality path – for example, quality (per emerging view 4).

Major projects that are certain to happen but where the timing and cost is still uncertain

80. In a situation with these characteristics, for example a major capex project like Whitecliffs, we consider a CPP would be required, because the impact of the project on consumers means that it requires the level of scrutiny provided by a CPP (as per the proportionate scrutiny principle). The CPP would be full scope because all the inputs needed to replace the DPP with a CPP would be required. However, in applying our proportionate scrutiny principle, we would not need to focus our evaluation of the proposal on those inputs that had already been scrutinised when setting the DPP or that had a relatively low potential impact on consumers (per emerging view 3).
81. Colonial First State's submission on the gas workshop sets out what it sees as appropriate information requirements, stakeholder consultation, verification and evaluation criteria for a major capex approval process via a DPP reopener.⁴⁰ For example, it submits that self-certification with no audit would be appropriate, in keeping with the low-cost nature of DPP. However, we do not think that it is appropriate that a project, such as Whitecliffs, with such a high potential impact on consumers (particularly on security of supply) should be subject to such minimal verification requirements (as per the proportionate scrutiny principle).

³⁹ To the extent that other, business-as-usual expenditure, would likely have been scrutinised in setting the DPP.

⁴⁰ Colonial First State, submission in response to IM review gas stakeholder forum workshop held on 8 December 2015 (28 January 2016), table 4.1.

82. Therefore our emerging view is that this demonstrates that a CPP – under which greater verification requirements, such as audit and independent verification, are applied – is a more appropriate mechanism with which to consider and accommodate a project such as Whitecliffs in a price-quality path.

Attachment A: Summary of current settings of DPP/ CPP tailoring mechanisms and emerging views

83. This purpose of this attachment is to summarise, in respect of each of the DPP, CPP and the path change mechanisms within them:

83.1 The fixed (ie, statutory) characteristics of the mechanism;

83.2 The current settings in respect of the mechanism (ie, characteristics set in the IMs, 52P determinations, or in our current practices); and

83.3 Our emerging views as they relate to the mechanisms.

	DPP (as set)	DPP pass-through/ recoverable costs	DPP reopener (reconsideration)	Single-issue CPP	CPP (as set)	CPP pass-through/ recoverable costs	CPP reopener (reconsideration)
Key statutory characteristics	<ul style="list-style-type: none"> Relatively low-cost Commerce Commission (CC) bears the cost of determination (passed on to industry through general levies) 53P limitations on how the CC sets a DPP – eg, restriction on benchmarking IMs must specify key inputs, eg, asset valuation, cost of capital 	<ul style="list-style-type: none"> Costs that can be passed through to prices must be specified in the IMs 	<ul style="list-style-type: none"> Only affects path for the remainder of the DPP period. Should accommodate issues affecting multiple suppliers (4+) that arise after the DPP is set (per High Court in Wellington International Airport Ltd & Ors v CC) Potentially supplier, CC, or consumer initiated We bear the cost of reconsidering the DPP (passed onto industry through levies) 	<ul style="list-style-type: none"> Not expressly contemplated in the legislation Same statutory constraints apply as a full scope CPP – described in the next cell to the right 	<ul style="list-style-type: none"> IMs must set out relevant scrutiny requirements and key inputs New regulatory period can be 3-5 years Only suppliers can apply and once during a DPP period. Cannot withdraw proposal once submitted Can agree to IM variations Applicant bears the cost of determining CPP CPP can extend across multiple DPP periods 	<ul style="list-style-type: none"> Costs that can be passed through to prices must be specified in the IMs 	<ul style="list-style-type: none"> Only affects path for the remainder of the CPP period. Changes will only affect path for the remainder of the CPP period Potentially supplier, CC, or consumer initiated
Current setting – Key Features	<ul style="list-style-type: none"> Accept suppliers capped (120%) AMP forecasts for network capex Generic approach for calculating forecasts for opex –some supplier specific inputs Historical performance used for quality Allow additional revenue to some suppliers to reduce likelihood of a CPP application 	<p>Pass-through costs</p> <ul style="list-style-type: none"> Identified costs, outside the control of the supplier - passed through to prices automatically Can add new levies as pass-through costs in a 52P amendment, where they meet certain criteria set out in the IMs <p>Recoverable costs</p> <ul style="list-style-type: none"> Category of costs that are only partially in control of the supplier – CC provides some scrutiny through an approval processes 	<ul style="list-style-type: none"> Reopener triggers: error, misleading information, catastrophic event, regulatory/legislative change 1% materiality threshold Reopener events are only a trigger – we can decline to reopen where we consider that a path change is not appropriate in the circumstances Path can only be altered to the extent necessary to correct for the event that triggered the reopener 	<ul style="list-style-type: none"> Currently only available for a quality standard variation Scrutiny required is only relevant to extent of quality standard variation 	<ul style="list-style-type: none"> Significant information, consumer consultation, verification and audit requirements 	<p>Pass-through costs</p> <ul style="list-style-type: none"> Identified costs, outside the control of the supplier - passed through to prices automatically Can specify new pass-through costs in a CPP determination, where they meet certain criteria set out in the IMs <p>Recoverable costs</p> <ul style="list-style-type: none"> Category of costs that are only partially in control of the supplier – CC provide some scrutiny through an approval processes 	<ul style="list-style-type: none"> Reopener events are only a trigger – we can decline to reopen where CC considers that a path change is not appropriate in the circumstances Contingent and unforeseen project reopener available for gas transmission

<p>Summary of relevant emerging views</p>	<ul style="list-style-type: none"> We are open to opportunities to take a more tailored approach to setting the DPP where this can be done without significantly increasing cost 	<ul style="list-style-type: none"> Current approach is appropriate –pass-through and recoverable costs should be used for issues that are largely outside the suppliers control and therefore do not require thorough scrutiny We are open to expanding the range of pass-through costs that can be specified via a DPP determination, and when this can be done 	<ul style="list-style-type: none"> We are open to expanding the range of circumstances in which we make DPP reopeners available where: <ul style="list-style-type: none"> Appropriate level of scrutiny can be achieved at a relatively low cost Input can be isolated Tailoring is low impact on consumers Time did not allow when setting DPP Tailoring is sought for multiple suppliers (4+) Reopeners could potentially be suitable for single inputs, eg: <ul style="list-style-type: none"> CPRG – where it could be better tailored for a supplier at the beginning of the period Quality standards – where historical performance is not a good measure for that supplier 	<ul style="list-style-type: none"> We consider that single-issue CPPs are not appropriate because: <ul style="list-style-type: none"> Problems with period alignment Asymmetry between suppliers and consumers Interdependencies with other aspects of the path Uses supplier’s one CPP opportunity for the regulatory period. CPPs should always be full scope – though proportionate scrutiny principle should apply. We should remove quality only CPPs – and replace with a new quality reopener provision 	<ul style="list-style-type: none"> We should apply the proportionate scrutiny principle in continuing to refine the CPP requirements and in assessing CPP proposals We are open to considering approval of costs incurred prior to CPP approval We are also continuing our work as part of the IM review to make the CPP requirements simpler and more cost-effective 	<ul style="list-style-type: none"> Current approach is appropriate - CPP pass-through and recoverable costs accommodate issues that are largely outside of the supplier’s control – therefore do not require thorough scrutiny We are open to expanding the timing of when new pass-through costs can be specified in a CPP determination 	<ul style="list-style-type: none"> We are open to adding CPP reopeners for major contingent and unforeseen projects for GDBs and EDBs
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