



## **Submission to the Commerce Commission**

on

Input methodologies review:  
draft decisions papers

4 August 2016

# Contents

Introduction..... 3

We support the implementation of a revenue cap..... 3

Future impact of emerging technologies ..... 6

Related party transactions ..... 7

Electricity Authority’s letter ..... 8

Closing Comments..... 9

## Introduction

1. We welcome the opportunity to submit on the Commerce Commission's consultation *Input methodologies review: draft decisions paper* (draft decision). This submission focuses on the issues of:
  - i) form of control<sup>1</sup>
  - ii) the future impact of emerging technologies in the energy sector<sup>2</sup>
  - iii) related party transactions<sup>3</sup>.
2. In this submission we also respond to the assertions in the Electricity Authority's letter *Possible implications for efficient distribution pricing of a decision to change the form of control for electricity distribution business*, dated 30 May 2016.
3. In all matters our views are expressed in the submissions by the Electricity Network Association (ENA) and PricewaterhouseCoopers (PwC).
4. No part of our submission is confidential.

## We support the implementation of a revenue cap

5. We support the commission's proposal to change the form of control from a weighted average price cap (WAPC) to a revenue cap<sup>4</sup>. We share the commission's view that a revenue cap:
  - better meets the purpose of Part 4 by removing the quantity forecasting risk under a WAPC
  - incentivises EDBs to price efficiently by removing the disincentives to restructure prices by removing compliance and revenue recovery risk
  - incentivises EDBs to invest in unconventional network solutions that can support energy efficiency and demand-side management (e.g., battery storage to manage peak load)
  - while shifting demand risk, in the form of price volatility, from EDBs to consumers the shift in risk only occurs within each regulatory period and not between regulatory periods as is the case under a WAPC.

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<sup>1</sup> Commerce Commission, *Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower*, 16 June 2016.

<sup>2</sup> Commerce Commission, *Topic paper 3: The future impact of emerging technologies in the energy sector*, 16 June 2016.

<sup>3</sup> Commerce Commission, *Topic paper 7: Related party transactions*, 16 June 2016.

<sup>4</sup> *Supra* n1, paragraph X3, at page 122.

6. We also support the unders and overs mechanism as it provides an effective wash-up of the difference between actual and allowed revenues in each year. However, we have reservations with supporting the proposed caps and collar on the wash-ups; and proposed constraint on the average price increase.

### *Caps and collars of the wash-up mechanism*

7. Our reservation in supporting the caps and collar of the wash-up comes from the lack of the detail needed to determine the form which the caps and collar would take. It is our understanding of the framework that the details of the caps and collar would be worked through as part of the 2020 default price-quality path (DPP) reset. Agreeing to a mechanism now without knowing the detail until later is not without risk.
8. For example, in its draft decision the commission states—

We propose an annual wash-up of the difference between the revenue received and the allowable revenue adjusted for CPI, pass-through and recoverable costs, subject to a cap on the amount that can be added to the wash-up account balance which would apply following a large demand shock, such as a catastrophic event.<sup>5</sup>
9. The commission does not quantify what is a ‘large demand shock’ and loosely associates the cap with a catastrophic event. There appears to be no other discussion on either what a large demand shock is or why it is appropriate that a cap be applied to an EDB that has experienced a catastrophic event.
10. Further, the caps and collar appears to contradict the premise that under the regulatory framework EDBs will earn a normal return. We fail to see how after implementing such a mechanism an EDB would be ‘kept whole’<sup>6</sup>.
11. An unintended consequence could be to prevent an EDB from earning a normal return in one regulatory period, which could result in claw-back being required in a future regulatory period. For example, under the current DPP Determination<sup>7</sup> our prices are capped at CPI +11%.

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<sup>5</sup> Supra n1, paragraph 106, at page 147.

<sup>6</sup> The draft decision does not make any reference to EDBs being kept whole. We are referring to comments made by Sue Begg at Downstream 2016 that the regulatory framework would be set to ensure that EDBs are kept whole. We have taken this to mean that EDBs will be allowed to earn a normal return. The caps and collar appear to be a distortion to earning a normal return.

<sup>7</sup> Commerce Commission, Electricity Distribution Services Default Price-Quality Path Determination 2015 (consolidating all amendments as of 9 July 2015), 9 July 2015, Schedule 2: Annual rates of change. A copy of the current DPP Determination can be found at <http://www.comcom.govt.nz/regulated-industries/electricity/electricity-default-price-quality-path/default-price-quality-path-from-2015/>

12. On the face-of-it this would appear to be a great position to be in. We in effect have a green light from the commission to increase prices each year above CPI. However, our experience will tell you that having prices increases that are higher than CPI are very difficult to justify to consumers. Even though the price increases are a justifiable catch-up, consumers do not accept that they are paying more today because they paid too little in the past.
13. To earn a normal return it could be envisioned that an EDB would be put in a position of needing catch-up in later regulatory periods. This across period recovery is a contradiction of the benefits of changing the form of control from a WAPC to a revenue cap.
14. It is our position that putting in place a mechanism that would require catch-up to earn a normal return should be avoided. Consumers should pay the true costs of service provision in the periods in which those costs are generated. A mechanism that prevents this will cause consumer mistrust and disgruntlement.

### *Constraint on average price increase*

15. The commission proposes to give itself the discretion to limit the percentage increase in the weighted average price from one year to the next if it deems it necessary to do so. The constraint was designed for gas transmission, but the commission is of the view the same constraint should be included in the IM to give it the discretion to be applied to EDBs at some time in the future.<sup>8</sup>
16. We do not support the proposed constraint on average price increases on two grounds:
  - i) the commission putting into place allowances now for a mechanism that it may, or may not introduce in the future unnecessarily introduces uncertainty
  - ii) such a mechanism is not needed under a revenue cap.
17. If the commission is of the view that a mechanism is required then it should be consulting on it now by giving us the necessary detail in this draft decision. As the commission has not given us any detail around how a constraint on average price increase would be applied to EDBs we can only assume that the commission are of the view that it is not needed. Agreeing to the commission reserving its discretion to introduce any mechanism in the future introduces uncertainty, which is a risk that is unreasonable to ask EDBs to bear.

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<sup>8</sup> Supra n1, paragraph 113, at page 148.

18. The draft decision gives an example ‘...the average price cannot increase by more than X%...’ at paragraph 113; and at footnote 50 makes reference to the proposed compliance process that is included in the gas DPP implementation paper and states that ‘...[w]e could adopt a similar process for EDBs at the next reset also.’
19. But neither reference provides appropriate details around the EDB context and accordingly we are of the view that the commission is not firm in its view of the need to introduce such a mechanism. Through its proposal the commission appears to want agreement to reserve its discretion for a later date. We cannot agree to this and are surprised the commission have asked EDBs to do so.
20. Perhaps more fundamentally we disagree that there is a need to constrain the average price increase under a revenue cap at all. A price constraint is a tool used under a WAPC. We support moving away from a WAPC because we are of the view a revenue cap is a better form of control. A hybrid revenue cap/WAPC is not a better form of control than the current WAPC. Accordingly we do not support the change in the form of control where that change is a hybrid.
21. The commission argue that a constraint on average price increases is needed to prevent price shocks. We are of the view that EDBs are best placed to scope and manage price shocks. On the whole EDBs are disincentivised from allowing a price shock due to the resulting consumer backlash. However, there are times that an EDB might want a price shock.
22. For example, where a group of consumers’ behaviours are driving costs and EDB might want to send a pricing signal to change that behaviour immediately. One of the best ways to have a sudden change in behaviour is to shock consumers into changing behaviour. Though such a move would be rare and need very careful consideration before executing it is no less a legitimate pricing decision. Accordingly, this a decision that the EDB should be making as it is the EDB that holds the necessary information to make that decision and not the regulator.

## **Future impact of emerging technologies**

23. We agree that changes are not needed to the IMs, at this time, to address the future impact of emerging technologies in the energy sector.<sup>9</sup> We also agree with the commission’s proposal to allow EDBs to recover the cost of assets more quickly by allowing EDBs to apply for a net present value (NPV) neutral shortening of the

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<sup>9</sup> Supra n2, paragraph X6, at page 304.

remaining life of the assets<sup>10</sup>.

24. As the current IMs support suppliers to use emerging technologies to explore potential and future consumer benefits and the current cost allocation IMs provide the appropriate level of transparency where a monopoly is participating in a competitive market.
25. However, we do not agree with a mandated cap of 15%<sup>11</sup>. We are of the view that the amount of the cap could be highly dependent on the type of emerging technology being invested in. An emerging technology associated with smart grids such as automated switches is likely to remain in the field and be relevant for some time. Other emerging technology such as IT applications associated with controllable load is likely to evolve and become redundant relatively quickly.
26. Accordingly, a blanket cap of 15% seems short sighted. Instead we recommend that the commission state that caps will apply, but that the level of the cap is part of the application process.
27. We recommend that the commission include in its guidance on the criteria for approving an application, the basis on which proposed caps will be considered.

## Related party transactions

28. We support the commission's proposed approach to retain the current related party transaction provisions in the IMs on the understanding that it will further explore whether the identified issues amount to a broader problem and consider what the best solutions to the problems identified might be.<sup>12</sup>
29. We agree that the benefits of finding a solution now without having fully defined the problem are unlikely to outweigh the benefits of taking more time.<sup>13</sup> And we are comfortable that the further work is likely to extend beyond December 2016.
30. Our views as to why the review should occur differ from that of the commission's in that our issues are with the application and usability of the related party transactions rules whereas the commission's issue appears to be the potential for suppliers to be earning above normal profits under the current rules.
31. We note that the commission hasn't evidenced its concerns in the draft decision.

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<sup>10</sup> Supra n2, paragraph X9, at page 304.

<sup>11</sup> Supra n2, paragraph X9, at page 304.

<sup>12</sup> Supra n3, paragraphs X1.3 and X7, at page 767.

<sup>13</sup> Supra n3, paragraph X6, at page 767.

Further, its own paper *Profitability of Electricity Distributors Following First Adjustments to Revenue Limits*<sup>14</sup> strongly indicates that EDBs are not earning above normal returns.

32. None the less, on the understanding that a review needs to occur irrelevant of the differing views as to the reasons driving the need, we support the commission's approach.
33. Our strong preference is that, given the commission will have extra time to consider the problems definition, the related party rules in the information disclosure (IDs) be reviewed in parallel with the IM review. A parallel review will ensure that the two determinations are consistent; or at least are not inconsistent.
34. We encourage the commission to hold workshops to further scope related party transaction matters and would be keen to participate if the commission were to do so.

## Electricity Authority's letter

35. We are concerned that the assertions in the Electricity Authority's letter could influence the commission's decision to apply a revenue cap as the form of control. We are of the view that the Authority has misunderstood the economic literature that is widely available on applying a revenue cap as a form of control and accordingly has asserted that a revenue cap would result in less efficient pricing structures than a WAPC.
36. In its letter the Authority states that '[it] would like to better understand the extent to which a revenue cap could affect [EDBs] incentives to adopt efficient prices'. One of the best pieces of work done on the issue of revenue caps versus WAPC was done by the Independent Pricing and Regulatory Tribunal of New South Wales<sup>15</sup> (IPART) in 1995.
37. Chapter 4 of the IPART paper goes into great depth to explain how efficient prices are better supported under a revenue cap, with wash-up mechanisms (i.e., a pure revenue cap) than is the case under a WAPC. The paper makes the statement that—

The central assumption behind the advocacy of revenue-cap regulation is that the utility can affect the demand-curve for energy. This assumption is not usually made in the economic analysis of price-cap regulation. This may be why the standard

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<sup>14</sup> Commerce Commission, *Profitability of Electricity Distributors Following First Adjustments to Revenue Limits—Summary and Analysis*, 8 June 2016.

<sup>15</sup> <http://www.ipart.nsw.gov.au/Home>

economics literature ignores revenue caps.

Those concerned with energy efficiency point to discrepancies between marginal costs and prices, and to the possibility that utilities can significantly influence demand through DSM programs. If these assumptions are correct, then they need to be accounted for in the analysis of regulatory incentives.<sup>16</sup>

38. It is understandable that the Authority is mistaken in its assumption that a revenue cap would result in less efficient pricing than a WAPC. As the market regulator the Authority's speciality is market regulation and not economic regulation; and more importantly it does not have access to the detailed information about the structure of EDBs costs and prices that it would need to have to appropriately analyse both forms of control.
39. The IPART paper provides a simplified model that captures the most essential features of both forms of control that the Authority could easily apply and thereby reconsider its assertions.
40. Accordingly, we recommend that the commission bring the existence of the IPART paper to the attention of the Authority and direct it to the information that is held in the information disclosures. As the commission's speciality is economic regulation the commission may also be in a position to assist the market regulator with its analysis.

## Closing Comments

41. We hope that our submission is helpful to the commission. We are happy to discuss our opinions further with the commission should it find it useful.
42. The main contact for this submission is:

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<sup>16</sup> IPART, Revenue Caps vs. Price Caps: Implications for DSM, Steven Soft, 11 November 1995. A copy of the paper can be found at <http://stoft.com/metaPage/lib/Stoft-1995-Rev-Caps-Dmnd-Side-Mngmnt.pdf>