

19 December 2018

Open letter

Dear Stakeholder

Update following feedback on Powerco and Wellington Electricity customised price-quality path processes

1. In August 2018, we received feedback from stakeholders in response to our July 2018 open letter requesting feedback on the customised price-quality path processes for Powerco and Wellington Electricity.¹
2. The purpose of this letter is to update stakeholders now that we have considered the feedback. In summary:
 - 2.1 we do not think it is necessary to make any amendments to the customised price-quality path provisions of input methodologies ahead of the next customised price-quality path application;² and
 - 2.2 we stress the importance of customised price-quality path applicants engaging with us early in their preparations so that our respective expectations are aligned. In the attached table we have made observations that inform our expectations of applicants in submitting a customised price-quality path proposal.

We thank the parties that provided us with feedback during the submission process.

Kind regards



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¹ Refer to: <https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-customised-price-quality-path/wellington-electricitys-20182021-cpp?target=timeline>

² Our current expectation is that Aurora will be the next applicant in 2020.

Attachment A: Observations from submissions

Topic	Observations
<p>Consideration of alternatives</p>	<p>There is potential to change the input methodologies (IMs) for this topic in the future. However, this is an evolving area and we do not consider a formal change to the IMs is appropriate at this stage. We will work with applicants to ensure options to achieve the lowest lifetime costs are explored with stakeholders. We would provide guidance on the extent to which we consider consultation on alternatives with third parties would add value in considering the issues driving the proposal.</p> <ul style="list-style-type: none"> - The majority of submitters agree that consideration of alternatives is important for major projects and they support stakeholders being provided with an early indication of network investment drivers. There is general support for making supporting material for the consideration of alternatives public early to incentivise a more consumer-focused approach in the customised price-quality path proposal. - However, they think it is inappropriate to use the Transpower Capex IM process as a model for the customised price-quality path process due to network and business differences. - One submitter considers it inappropriate to market test all major investments considering quality supply obligations and supply risks. Another submitter stated that supply agreements may make consideration of alternatives inappropriate. - In the Transpower individual price-quality path (IPP) reset project we are further examining how Transpower has been applying the consideration of alternatives in its customer engagement and in its project prioritisation. The results of this analysis will be available for consideration when the next customised price-quality path proposal is being planned for. Although submitters asked for further guidance on this point, there is limited value in doing this before we complete the Transpower 2020 to 2025 (RCP3) reset evaluation. - We agree with the idea that making the supporting material for the consideration of alternatives public early would incentivise a more consumer-focused approach. - We have also been engaging with the Electricity Authority on this topic in the context of the Electricity Pricing Review. - Submissions suggested possible thresholds and processes that could be specified if we were to codify the requirements on this issue (eg, the Australian \$5 million threshold to require market testing, the Australian Regulatory Investment (RIT-D) Test for Distribution, and a suggestion that there should be a requirement to consult where the incremental change in services is material – suggests 5% threshold).

	<ul style="list-style-type: none"> - Submitters suggested that disclosure by suppliers through the asset management plan in information disclosure (ID) may be a more effective way of achieving the desired outcomes. This should be considered when our recommendations are formulated from the current asset management plan review.
<p>Use of cost-benefit analysis</p>	<p>We will engage with potential customised price-quality path applicants upfront to determine where cost-benefit analysis (CBA) is best used, as we see a stronger justification for expenditure where it is supported by a well-informed CBA.</p> <ul style="list-style-type: none"> - There seems to be broad acceptance that mandating the use of CBA is not necessary for the overall evaluation of a customised price-quality path, but there is acknowledgement that it can be an important part of the process of preparing a customised price-quality path proposal. - Submitters that do not support the requirement to use a CBA for overall evaluation suggest that a CBA is suitable to determine the costs and benefits of specific projects. However, it should not replace the current assessment criteria. - There appear to be benefits in having a discussion on comparing alternative assessment techniques to the CBA and how obstacles to applying a CBA using a “genuine counterfactual” might be removed in future. - Applying an asset criticality approach might improve the robustness and transparency of a CBA assessment of customised price-quality path proposals. - Orion currently uses condition-based risk management (CBRM) models to quantify risk. Asset criticality forms part of the building block in quantifying risk. This is a type of CBA when different programme scenarios are compared with the goal of maintaining overall asset class health and reliability. Benefits could be quantified by using VOLL, VOI and customer surveys.
<p>Long term pricing impact (beyond the customised price-quality path period)</p>	<p>We are currently not minded to amend the customised price-quality path IMs to add this requirement. We can work with applicants and request an estimate of the long term pricing impact of their proposal without an IM change.</p> <ul style="list-style-type: none"> - Submitters commented that long term price forecasts are uncertain, however shortening the horizon does not reduce this uncertainty, it instead conceals the expected impact. - We consider a better approach is to have some estimate of the longer term pricing effect, particularly the transition between regulatory periods, even if this means we need to acknowledge that the impact beyond 5 years would only be indicative.

	<ul style="list-style-type: none"> - It has been suggested that the full pricing impact would be more transparent with a counterfactual methodology - eg, using a constant WACC which would separate the effect caused by the change in WACC. - We have received suggestions of alternatives to amending the IMs: <ul style="list-style-type: none"> • amend the electricity distribution business (EDB) ID requirements (clause 2.4.1) to include a clause on forecast prices. • amend the EDB IMs to require publication of a pricing strategy and amend EDB ID clause 2.4.4 to include price changes for a 10 year period.
<p>Calculating revenue and pricing changes (within the customised price-quality path period)</p>	<p>We are currently not minded to amend the customised price-quality path IMs. We are considering a standard methodology for calculating price impact as part of the current 2020-2025 default price-quality path reset project, although we are aware of limitations with this approach.</p> <ul style="list-style-type: none"> - We have been cautioned against applying a prescriptive approach to assessing the impact on price, since the use of averages and sensitivity of price outcomes might be misleading. - It has been suggested that the standard consumer concept (eg, the MBIE typical consumer) is misleading, since EDBs have consumers on different tariffs and different proportions of commercial and residential with different levels of usage. - It is generally accepted by submitters that discussion needs to move off average price impacts of customised price-quality path proposals and instead consider pricing methodologies and cost to serve models to forecast the allocation of customised price-quality path costs to the main EDB pricing plans: <ul style="list-style-type: none"> • The focus should be on the price impacts of the customised price-quality path to consumers in the supplier's region, rather than by comparison with the prices of other EDBs. • Applicants should communicate price impacts and benefits delivered to those customers with individually negotiated contracts. - It was also suggested that price changes should first be communicated with retailers before consultation with consumers, because in most cases they pass through the cost to the end consumers.
<p>Delivery and accountability</p>	<p>We will work with individual customised price-quality path applicants to explore delivery and accountability commitments. We expect the deliverability report that Powerco is required to undertake under its customised price-quality path will be a good starting point for discussions.</p>

	<ul style="list-style-type: none"> - There seems to be general acceptance that EDBs should be accountable for delivering changes in service quality and lines charges approved under their customised price-quality path. - It is considered that if consumer consultation is improved before an application is formally lodged, then stakeholders will have a better benchmark to measure what was promised. Therefore, the first step to improving delivery and accountability is improving consumer consultation. - The question of additional quality measures should be considered as part of the link between price and quality and is secondary to improved quantification of the price-quality trade-off proposed in the customised price-quality path proposal. - There should be flexibility for the fact that situations in a forecast can change and alternative solutions can become favourable over time.
<p>Link between price and quality</p>	<p>We will continue to engage with the industry on the best way to ensure that investments impact on quality is considered in the development of customised price-quality path proposals and in consultation with consumers.</p> <ul style="list-style-type: none"> - All submitters except Vector argue that current asset health measures and the impact of investment on network reliability are not well developed across the EDB sector. They would not therefore form a good basis for evaluating the link between price and quality. There is acknowledgement of the need to further develop their asset criticality framework before introducing measures that address the link between price and quality. - Major Energy Users Group, in particular, supports the rapid development of improvements in the assessment of asset reliability, which we support. - Submitters have stated that we need to do more to guide EDBs and others about how price and reliability trade-offs should be considered within existing regulation. - There are good examples we can point to, such as Orion. As discussed above, Orion applies CBRM models to quantify risk and build up risk-based work programmes. Investment decisions are subject to documented asset management reports and business cases which includes, as appropriate, relevant alternatives. Approval is sought from management and the Board as appropriate. - Price and quality trade-offs during a regulatory period can then be communicated with: <ul style="list-style-type: none"> • workshops with customers • surveys • establishing a customer advisory panel • focus groups; and / or • seminars.

<p>Consumer consultation</p>	<p>We are currently not minded to amend the customised price-quality path IMs. Instead we propose to work with individual applicants to understand the issues driving their proposals, and how the various options for investment or quality in the proposal could best be presented to consumers for consultation.</p> <ul style="list-style-type: none"> - There is a broad suggestion that we provide further guidance, including the specification of established frameworks such as the Australian IAP2 Spectrum. - Feedback includes the suggestion that our interpretation of consumer consultation during the Powerco customised price-quality path was overly simplistic and that it needs to be recognised that some consumers have a low interest in engaging. An idea from the submissions that we could consider in establishing a good practice norm is to include the use of a separate verifier with expertise in public consultation (something that Transpower's RCP3 verifier has also suggested to us) and allow for different tiers of engagement for different stakeholders. - We have been cautioned against the process becoming too qualitative rather than giving weight to quantitative assessments of consumer preferences. Consultation with consumers is currently not considered effective because there is not a requirement for the effects on prices and quality of the proposal versus the counterfactual to be made clear. It is suggested that we should set a default minimum process for consumer consultation. - The feedback suggests that suppliers consider early engagement with customers is an expected part of the normal operations for major projects and that there are already incentives for EDBs to communicate with their consumers. - An idea to consider for further development is a forum that allows an EDB to share information and build knowledge within a group of customers over time on its business and investment decisions and solutions. This is a variation on the type of forum that some EDBs and Transpower are currently developing.
<p>Verification</p>	<p>We are currently not minded to amend the verification provisions in the customised price-quality path IMs. We will continue to engage with applicants to get the best out of the verifier process, including early engagement with the verifier.</p> <ul style="list-style-type: none"> - Our experience with verifiers are improving with each implementation. We continue to think the mechanism has good value in our customised price-quality path proposal evaluation approach.

	<ul style="list-style-type: none"> - The experience to date with customised price-quality paths highlights the importance and value of early engagement with us, the regulated business, and the verifier. It would be useful for the verifier to signal early in the verification process the projects and programmes it intends to verify. This would enable a more efficient process where the business can focus time and resources on preparing the necessary information. - The feedback suggests there is still some scepticism on the rationale for and net contribution of the verifier. It questions the use of the verifier since it has no current or long term relationship with customers and consumers, and suggests it has weakened the pressure that consumers put on EDBs and us to improve efficiency. This perspective is at odds with our experience.
<p>Defining and applying proportionate scrutiny</p>	<p>We consider proportionate scrutiny remains appropriate for the customised price-quality path process. Stakeholders may note that we provided further guidance on how the principle could be applied as part of reviewing Transpower’s RCP3 proposal.³</p> <ul style="list-style-type: none"> - Stakeholders consider it would be appropriate to provide guidelines which clarify the principle. - Stakeholders consider that the issue of better defining proportionate scrutiny can be resolved by us outlining our scrutiny plans for each customised price-quality path proposal early in the process.

³ Commerce Commission “Our process, framework and approach for setting Transpower’s expenditure allowances, quality standards and individual price-quality path for 2020 to 2025” (25 October 2018), Chapter 5 and Attachment B.