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John McLaren
Manager (Part 4)
Regulation Branch
Commerce Commission
Wellington

Sent by email to: regulation.branch@comcom.govt.nz

Dear John,

Proposed Electricity DPP Compliance Requirements

1. Vector welcomes the opportunity to provide a submission on the Commerce Commission's (Commission) consultation paper *Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors*, dated 18 July 2014 (Compliance Requirements Paper). This submission also comments on the draft DPP determination.

2. This submission is one of several in response to the package of DPP and IM consultation papers released in July 2014. This submission focuses on all proposed compliance requirements except for those relating to quality standards, which are responded to in our submissions on the Quality Targets and Incentives consultation paper and the Main Policy Paper.

Pass-through and recoverable costs

Revenue cap for transmission charges

3. As noted in our submission on the Main Policy Paper, Vector welcomes the Commission's agreement to implement a form of revenue cap for transmission charges, which will mean these recoverable costs are not subject to forecast risk

or volume risk. We were pleased to be able to assist the Commission with drafting of this proposal.

4. However, Vector considers the Commission's proposal not to allow any negative balance of unrecovered costs to be carried over into the next regulatory period[1] is:

   a. Unexplained and unsupported by any analysis; and

   b. Contrary to the Commission's own principle that "distributors should be able to recover pass-through and recoverable costs in full".[2]

5. Vector proposed a requirement to have a zero or negative balance at the end of each regulatory period as a means to remove the risk that EDBs would continually over-recover and never pass the over-recovery back to consumers. A requirement to have a zero or negative balance on a regular basis seemed a pragmatic way to achieve this outcome.

6. However, as the Commission should be aware, in practice the requirement to have a zero or negative balance in the final year of a regulatory period will mean that EDBs will almost always under-recover transmission charges in that year. This is because the need to forecast both quantities demanded in the year and the level of the transmission charges themselves will create a high risk of forecasting error. EDBs will under-forecast and, most likely, under-recover in order to avoid the risk of a price path breach (in the context of the Commission reacting strongly to some recent price path breaches of relatively small dollar values resulting from forecast errors).

7. This under-recovery is only acceptable if the negative balance can be carried forward into the following year. If that is prevented, EDBs will always expect to under-recover their transmission charges, thus defeating the Commission's own principle as quoted above and affecting their ability to fund other expenditure. We do not believe this is reasonable. Vector **recommends** the Commission provides for a negative balance to be carried over to the following regulatory period. We would be happy to provide suggested drafting to achieve this if that would assist.

Flexibility regarding transmission charges

8. Vector also notes the Commission's concern that the drafting we proposed "may give distributors too much flexibility in calculating the annual amount they will

[1] Commerce Commission, *Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors*, 18 July 2014, paragraph 3.50.

[2] Main Policy Paper, paragraph 5.2.

recover for transmission charges." The Commission then suggests some options for limiting the flexibility.

9. The basis for the Commission's concern is not clear. The Commission does not set out why this flexibility is a bad thing. We would be interested to learn why the Commission considers providing flexibility to EDBs causes negative outcomes.

10. The proposals put forward by the Commission to address this flexibility are:

    a. Requiring transmission charges to be estimated on an annual basis; or

    b. Setting a limit on the transmission balance that may be carried over between assessment periods.

11. In our view, these proposals would increase the complexity of the revenue cap mechanism for no clear value. It seems they would both create new compliance risks for EDBs and item (b) would most likely mean that some transmission balances were not carried forward – thus meaning EDBs either over or under-recovered their transmission charges. In short, the proposals would seem to undermine the key aims of the transmission recoverable costs proposal of reducing forecasting and recovery risk, reducing compliance risk and ensuring EDBs recover their transmission recoverable costs in full, but not more than in full.

12. Vector has two alternatives to suggest:

    a. The Commission could require EDBs to report, in their compliance statements, to explain why the transmission balance is greater or less than zero and how they intend to address this in the following year; and/or

    b. There is no particular reason why the requirement for a negative balance should align with the five-year regulatory period. The Commission could require a negative balance to be achieved more frequently, for example every third year or one year out of any three years.

Other pass-through and recoverable costs

13. Also, as noted in our submission on the Main Policy Paper, Vector's preference remains for the revenue cap approach to be applied to all pass-through and recoverable costs. While we understand that separating out the smaller pass-through and recoverable costs from other charges may be an additional task for some EDBs, that task should only be challenging the first time it is applied, if it is challenging at all, while the benefits of reduced volume and forecasting risk will apply to all EDBs each year thereafter. Net benefits are therefore likely to be maximised by applying the revenue cap approach more widely. Based on the

draft IMs already prepared, we do not believe it would be a difficult task to re-draft the IM amendments to capture all pass-through and recoverable costs.

14. Vector therefore **recommends** the revenue cap be applied to all pass-through and recoverable costs, not just transmission recoverable costs.

Ascertainable costs – including recommendation for more flexible definition

15. If this recommendation is not accepted, Vector agrees that the ascertainable approach for the remaining pass-through and recoverable costs is preferable to the status quo.

16. However, Vector considers that the application of the ascertainable approach is currently too stringent. It requires regulated suppliers to be certain of the exact cost amount before they can recover any of the costs. If they are not certain then they cannot recover until the following year. While any outstanding amounts are recovered with the cost of debt, this still creates a revenue hole in the first year that can be significant and difficult to manage (for example, for Vector our non-ascertainable levies and rates are likely to be approximately $9.5 million in 2015/16). This single year of non-ascertainable costs is in reality never recovered, despite being incurred, which we do not believe is desirable or consistent with the Commission's principle that EDBs should be able to recover their pass-through and recoverable costs in full. Given the magnitude of the rates and levy costs, we consider that this is an important issue.

17. Therefore, we **recommend** that that DPP determination states, where pass-through and recoverable costs are not otherwise ascertainable, the EDB is able to recover a value up to 75% of the value paid in the previous full regulatory year for which information is available. A reference to the previous year's amounts is pragmatic as they are unlikely to change much on an annualised basis and will usually increase, meaning the risk of over-recovery is low – rates, for example, consistently increase. This proposal will allow recovery of the bulk of the levies (as one quarter of information is usually ascertainable) and the remainder (including a negative balance to return any over-recovery) can be carried into future years adjusted for the cost of debt.

18. Further, Vector disagrees with the proposal that the ascertainable test should be limited to costs incurred by the EDB no more than two years prior to the current assessment period.[3] This unnecessarily and unreasonably creates recovery risk for EDBs and again jeopardises the Commission's principle that pass-through and

[3] Compliance Requirements paper, paragraph 3.60.3.

recoverable costs are able to be recovered in full. There are circumstances in which costs may not be ascertainable in time to be recovered within the two-year window, which would risk them never being recovered. It is not clear what problem the Commission intends the two-year limit to solve. If the Commission is concerned with historical non-recovery being included in prices it could limit recovery to costs incurred, say, after 1 April 2015.

New approval requirements for recoverable costs

19. Although it is not stated explicitly, Schedule 5, clause 5 of the Draft DPP determination appears to require ex ante approval of Transmission Recoverable Costs before they can be included in prices. As noted above, this will create delays in recovery of these costs. It is also unnecessary as the costs will still be subject to ex post review. More importantly, the proposal is unworkable and Vector urges the Commission to reconsider.

20. The proposal is unworkable because the Transmission Recoverable Costs cannot be assessed until after Transpower advises its prices in late November (or later this year if the Commission delays its WACC decision). These costs must be included in prices notified before the end of December. There is then no available time for an ex ante approval process to be conducted before prices are set. Therefore subjecting these costs to an approval process by the Commission could result in over-recovery of Transmission Recoverable Costs in the event the Commission did not approve these costs after prices had been set. This creates unreasonable and unnecessary risk for EDBs

21. The Commission has also proposed that its approval will be required for three more recoverable costs:

    a. Distributed generation Avoided Cost of Transmission (ACOT);

    b. AUFLS/extended reserves charges;

    c. Energy efficiency and demand-side management (DSM) costs.

22. Vector does not support the new requirement for distributed generation ACOT payments to be subject to approval. This is not in place currently and the Commission has not identified any problems with the current arrangements. Payments are clearly required by the Electricity Industry Participation Code 2010 and the quantum of payments is straightforward to verify by reviewing documentation. There is no clear value that Commission approval would provide. Further, ex ante approval of these costs would be unworkable for the same reason as for transmission charges, discussed above.

23. Vector also does not believe it is necessary for the AUFLS/extended reserves charges to be subject to approval for this regulatory period. Evidence of invoices and rebates will be available and will provide clear evidence for directors and auditors of the amounts incurred. There is no need for an approval process or the costs that would create. If an approval process is introduced, this should be subject to review if/when the new charges are in place to determine if it is in fact required.

24. Vector agrees Commission approval is required for energy efficiency and DSM costs. However, we do not agree with the proposed timing of the approval – see below.

Price restructures

Price restructure clauses should be less detailed and more principled

25. Vector has reviewed the draft price restructure clauses within the draft determination. In our view they are overly detailed and it is unnecessary for this information to sit within the determination.

26. Clause 8.7 would sit better within the Reasons Paper. This is a statement that is obvious to all parties and adds no value.

27. Clause 8.8 sets out examples that would be more helpfully described in the Reasons Paper. In our view this clause should set out the appropriate principles that apply in the event of a price restructure, for example that quantities from the lagged period prices must reasonably relate or correspond to prices in the current Assessment Period (or similar wording).

28. Clause 8.9(b)(i) provides that, in the event of a price restructure requiring an estimate of quantities corresponding to prices, EDBs cannot estimate a quantity using forecast quantities. It is not clear to us what the intention of this clause is. We have inferred that this clause means that estimated quantities must be estimated for the lagged t-2 quantity period, rather than any other (future) period, but clarity on this point would be helpful.

Notification of price restructures in advance to the Commission adds no value

29. The Commission proposes that EDBs must notify the Commission at least 30 working days prior to any price restructure taking effect. Vector does not support this proposal as it does not add any value but does create additional compliance costs. As Vector must notify retailers of price changes at least 60 working days in advance, the Commission would have no scope to object to the proposed

restructure. Therefore providing the Commission with price restructure information in advance of the price restructure taking effect, but after prices have been contractually notified can serve no useful purpose. The information requested would be provided in the Compliance Statement at the end of the Assessment Period. Thus providing it in advance is duplicatory (and hence creates further costs) for no clear benefit. Vector **recommends** clause 8.9 is deleted from the determination or the Commission explains why it is necessary.

Definition of price restructure

30. The Commission also defines a price restructure in reference to a "load group". In the use-of-system agreements within the industry the standard term is "price category". Vector **recommends** changing the references to "load group" to "price category" in the draft determination and more generally across regulatory requirements to align with industry standard.

DSM initiatives compensation

31. As discussed in our submission on the Main Policy Paper, we broadly support the Commission's proposals relating to energy efficiency and demand-side management. However, we believe the process should include the provision of an ex ante view, at least at an in-principle level, on the foregone revenue calculation methodology.

32. Vector appreciates that the Commission may need to request additional information and welcomes the acknowledgement that the Commission will need to assess the relative costs of supplying the information and the value of the foregone revenues when making the request.

33. Vector **recommends** that the Commission commits to a specified and published schedule that sets out the process and timeframe in which it will assess the information and make a decision. This process should include reasonable time for additional information to be requested and provided, while still allowing a decision to be made in most circumstances in time for the foregone revenues to be recovered in the next assessment period (i.e. the assessment period that is two assessment periods after the one to which the foregone revenue relates).

34. Vector also **recommends** a streamlined process is applied where the methodology for calculating foregone revenues has previously been accepted by the Commission.

35. Finally, Vector **recommends** that schedule 5, clause 11 of the draft determination is amended to refer to the next two Assessment Periods, not just the next one. Firstly, it is likely that any efficiency saving achieved will last for more than one year and requiring an additional application the following year for the same saving is costly, inefficient and onerous. Secondly, it is necessary to recover these costs for at least two Assessment Periods (after which the reduction in demand will be reflected in lagged quantities).

Major transactions

36. The Commission has developed proposals to address situations where one EDB purchases assets from another EDB and the purchase results in consumers being supplied by a different EDB (major transactions). The Commission proposes a flexible arrangement where the EDBs involved in major transactions will agree between themselves how the allowable notional revenue, pass-through and recoverable costs related to the transaction are allocated between the EDBs.

37. Vector supports the Commission's proposal, which is a sensible approach that limits the need for complicated regulations in an area where the EDBs involved can reach agreement between themselves.

38. However, Vector notes there are some slight inconsistencies between the drafting of the DPP determination and what is said in the Compliance Requirements paper. We request clarification on these points:

    a. Paragraph 5.14 of the Compliance Requirements paper suggests that all EDBs who enter into a major transaction will need to provide notice of the transaction to the Commission (otherwise it is not clear how the compliance requirements would work). However, clause 10.1 of the DPP determination limits this requirement to those transactions that change asset values or notional revenues by more than 10%.

    b. Similarly, paragraph 5.15 of the Compliance Requirements paper suggests that all EDBs who enter into a major transaction will need to recalculate their SAIDI and SAIFI targets. However, clause 10.4(b) of the DPP determination limits this requirement to those transactions that require notification under clause 10.1.

39. Vector's preference is for the drafting of the determination. The reporting and re-calculating requirements should not be required for small transactions, such as those that fall below the 10% threshold.

Draft determination

Clause 8.4

40. This clause defines $Q_{i,t-2}$ with reference to the Assessment Period. But Assessment Period is defined in respect of the regulatory period, so this will not work in the first two years of the regulatory period where the year t-2 is in a previous regulatory period.

Clause 11.4

41. Subclauses (d) and (f) appear to be requiring the same information. Only one of these should be necessary.

42. It is not clear why the explanation required by subclause (g) – of the differences between actual and recovered pass-through and recoverable costs – is necessary using the ascertainable approach.

43. It is not clear why subclause (h) is necessary given the new approach for transmission charges. This subclause creates a reasonably involved process regarding these values which no longer seems to add any value.

44. Vector **recommends** this clause is reviewed with the new arrangements for pass-through and recoverable costs in mind and the unnecessary subclauses are removed.

Schedules 1 and 2

45. Vector **recommends** the following words are deleted from Schedule 1 clause 1: "and the Regulatory Period to which they specify". The specified MAR values apply only to the first year of the Regulatory Period, not to it in its entirety. For a similar reason, the heading of Table 1.1 should refer to the 2015-16 regulatory year, not the 2015-2020 regulatory period.

46. The heading of the first column of table 2.1 refers to starting prices when it should refer to rate of change.

47. Tables 2.1 and 2.2 should make it clear the rates of change are annual rates of change, not total rates for the entire regulatory period.

Schedule 5

48. In Schedule 5, clause 1(a) the Commission specifies that pass-through and recoverable costs except non-transmission recoverable costs and indirect transmission charges, must be ascertainable at the time prices are set to recover them.

49. This means transmission recoverable costs would need to be ascertainable. We assume this is an error – the whole point of the concept of transmission recoverable costs is that they can be forecast but any forecast errors can be washed up, thus ensuring recovery of the full amount, no more or less. To require transmission recoverable costs to be ascertainable risks leaving EDBs unable to recover revenues to meet approximately one third of their costs in the first year of the regulatory period. The financial impacts of this would be unmanageable.

50. Vector **recommends** the term "Non Transmission Recoverable Costs" in Schedule 5, clause 1(a) is replaced with the term "Transmission Recoverable Costs".

51. Vector also **recommends** deleting clause 1(c). This clause requires that in order for a cost to be included as a pass through cost or non-transmission recoverable cost it must not be able to be recovered from consumers or other parties, other than through prices. However, it is conceivable that these costs are arguably able to be recovered through any number of mechanisms other than prices, thus on the literal wording this clause frustrates the intent of enabling the costs to be recovered.

52. Vector considers that clauses 2, 3 and 4 would be significantly clearer if the Commission provided an equation, for example in a similar way to the gas DPP determination. This would remove any doubt of how the clauses should be applied.

53. It is not clear why clause 6(b) is necessary given the new approach for transmission charges. This subclause creates a reasonably costly process regarding these values which no longer seems to add any value.

Definition of system fixed assets

54. Vector welcomes the Commission's removal of the reference to Transpower assets in the definition of System Fixed Assets – this should remove the risk that an outage caused by a particular asset can count towards the compliance performance of both an EDB and Transpower.

Yours sincerely,

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