PRICEWATERHOUSECOOPERS

Submission to the Commerce Commission

on the

Starting Price Adjustments for Default Price-Quality Paths Discussion Paper

Made on Behalf of
18 Electricity Distribution Businesses

10 September 2010

Submission on Starting Price Adjustments for Default Price-Quality Paths Discussion Paper

This paper forms our submission on the Commerce Commission's (the Commission's) Starting Price Adjustments for Default Price-Quality Paths Discussion Paper (the Discussion Paper), which has been prepared by PricewaterhouseCoopers (PwC)on behalf of the following 18 Electricity Distribution Businesses (EDBs):

- Alpine Energy Limited
- Buller Electricity Limited
- Counties Power Limited
- Eastland Network Limited
- Electricity Ashburton Limited
- Electricity Invercargill Limited
- Horizon Energy Distribution Limited
- MainPower New Zealand Limited
- Marlborough Lines Limited
- Nelson Electricity Limited
- Network Tasman Limited
- Network Waitaki Limited
- Northpower Limited
- OtagoNet Joint Venture
- The Lines Company Limited
- The Power Company Limited
- Top Energy Limited
- Westpower Limited.

Background

1. On 30 November 2009 the Commission published a section 52P determination on the default price-quality path for EDBs – referred to as the Initial Reset Determination. The default price-quality path (DPP) under the Initial Reset Determination applies from 1 April 2010 until 31 March 2015 and is referred to as the Reset DPP.

2. In its Decisions Paper,[1] the Commission indicated that it had deferred starting price adjustments based on profitability assessments due to the relevance of the input methodology (IM) determinations to these. In addition the lack of business specific starting price adjustments under the thresholds which have applied to EDBs since 2003, along with the generic X factor within the DPP were cited as reasons for considering business specific starting price adjustments under the DPP.[2]

3. Accordingly the Commission has released a Discussion Paper which outlines a possible methodology for making starting price adjustments. The Discussion Paper infers that this methodology could be applied to adjust prices within the existing DPP period and also at each subsequent DPP reset. This submission is a response to that paper and considers the implications of it for EDBs.

Proposed Methodology

4. The proposed methodology for setting starting prices under a DPP is as follows:
   a) Consider historical Returns on Investment (ROIs) for each EDB and normalise for abnormal events;
   b) Develop an ROI band to be centred on a forward looking Weighted Average Cost of Capital (WACC) point estimate which is to be determined consistent with the cost of capital IM. Based on the draft IM this will be set at the 75th percentile of the vanilla WACC range;
   c) Ascertain whether the historical normalised ROI for each EDB subject to the DPP falls above, within or below the ROI band;
   d) Adjust Allowable Revenue under the DPP downwards consistent with the upper ROI band, for EDBs with normalised ROIs above the upper ROI band;
   e) Adjust Allowable Revenue under the DPP upwards consistent with the lower ROI band, for EDBs with normalised ROIs below the lower ROI band; and
   f) Make no change to Allowable Revenue under the DPP for those EDBs with normalised ROIs which fall within the ROI band.

5. We comment on each component of the proposed methodology in the remainder of our submission. However first we consider the regulatory framework set out in Part 4 of the Commerce Act 1986 (the Act) which pertains to the DPP for EDBs.

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[1] Commerce Commission, Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses, Decisions Paper, 30 November 2009, paragraphs 4.47 – 4.48
[2] Ibid, paragraph 4.49

Regulatory Framework

6. The DPP replaces the price and quality thresholds which applied to EDBs under the previous Part 4A regime. Some EDBs are now exempt from the DPP requirements due to their ownership structures. For those which are not exempt, the key implications of the DPP for them include:
    - The DPP price and quality standards are now binding as opposed to the thresholds which were effectively a screening mechanism;
    - The DPP must be consistent with the IMs, whereas no IMs existed under the thresholds regime;
    - The DPP is intended to be a relatively low cost regulatory mechanism, with a Customised Price-Quality Path (CPP) option available for EDBs seeking more business specific regulatory terms;
    - The DPP may not be set with reference to comparative efficiency benchmarking (which was used for the thresholds);
    - The DPP is to be set using one rate of change for a regulated service (subject to limited exemptions) whereas the thresholds applied different rates of change to each EDB; and
    - Starting prices under the DPP must be either:
        - Those which applied at the end of the preceding regulatory period; or
        - Prices based on the current and projected profitability of each supplier (as per Section 53P(3)).

7. Accordingly the regulatory provisions for the DPP are significantly different to the Part 4A thresholds. In addition an overarching purpose of Part 4 has now been established (previously a purpose statement was only included for Part 4A) and the purpose statement now includes specific recognition for incentives to invest and innovate in the infrastructure required to provide regulated services. Parliament also explicitly recognised that one of the key objectives of the amendments to the Act was to promote regulatory certainty for suppliers and consumers.

8. Thus the transition from the thresholds to the DPP is a significant step change in the regulatory provisions for EDBs. A number of important modifications have already been made in the Initial Reset DPP (for example changes to the manner in which quality performance is measured and assessed, changes to the derivation of the X factor and specification of pass through costs) however the proposed starting price adjustments will also be a significant change to the way in which the level of regulated prices are determined for each (non-exempt) EDB.

9. The price path threshold effectively commenced with starting prices equivalent to each EDB's weighted average prices at the time the 8 August 2001 Commerce Act Amendment was enacted. These have been rolled forward in the price path threshold with adjustments for CPI, X factors (which were intended to provide incentives for industry wide and business specific efficiency gains and some relative profitability adjustments between EDBs) and allowances for the recovery of pass through costs.

10. Since 2001, a major review of the regulatory asset valuation methodology was undertaken (and new Regulatory Asset Bases (RABs) were established in 2004). In addition a major review of the Information Disclosure Requirements (IDRs) for EDBs was undertaken and completed in 2008 (with significant changes in the manner in which ROIs were calculated).

11. In addition, the IM process which was initiated under the 2008 Commerce Amendment Act, is likely to result in further changes in the manner in which RABs are determined and regulatory profits are calculated. These determinations are to be made before the end of 2010, although it is likely to take some time to implement the changes.

12. Accordingly since the regulatory responsibilities for EDBs were transferred to the Commission in 2001 there has never been a normalisation of profit to RAB in the regulated prices applying to EDBs. The RAB developments which have occurred since 2001 have not been reflected in threshold price paths. In addition, the Commission has continually evolved its WACC estimates over that time, and EDBs have not had clear direction on the Commission's expectations in this respect. As a result, it is expected that for those EDBs which have met the regulatory expectations of Part 4A and have priced within their threshold price path, their historical ROIs (which are to be recast using the new IMs) will diverge from the benchmark that the Commission is likely to use for assessing starting price adjustments.

13. We submit that for these reasons the proposed starting price adjustment process is a significant change to the regulatory provisions for EDBs and the Commission should proceed with some caution.

14. We have considered and support the ENA's submission in this respect in particular that the Discussion Paper does not exhibit the same level of rigour and reasoning as included in the IM consultation documents.[3] We submit that this is unacceptable for a process of such significance for EDBs. We urge the Commission to consider further the ENA's submission

[3] Electricity Networks Association, Submission on Method to Adjust DPP Starting Prices, 10 September 2010

that the method for adjusting DPP prices should be an IM. We believe this would greatly assist achieve the regulatory certainty objectives (for suppliers and consumers) of the Act.

15. We also note that the Discussion Paper is silent on the likely sequencing of the implementation of the proposed methodology for EDBs for the existing DPP. One of the most important tests for a methodology is whether it is able to be implemented in a robust manner. Earlier papers have indicated that the Commission intends starting price adjustments to apply for EDBs from 1 April 2012,[4] however the Discussion Paper includes no assessment as to whether or not the proposed methodology is able to be implemented within this time frame.

16. We are somewhat concerned that the Commission intends to request non exempt EDBs to retrospectively apply the new IMs into historical disclosures, which will then need to be normalised and analysed before draft decisions are to be made by Q2/Q3 2011, according to the May 2010 Updated Process Paper. In parallel, if the Commission's proposed methodology is implemented, it will require ROI bands to be determined in some manner, using historical ROI data. We do not believe these requirements are straight forward and we are concerned that insufficient time is being provided for this work, which as noted above we believe is a significant step change in the regulatory provisions for EDBs and therefore is not able to be based on a precedent.

17. We refer the Commission to our earlier submission[5] on the Threshold Reset 2009 Discussion Paper.[6] This paper included the results of analysis undertaken by Meyrick and Associates for determining the X factor to apply for the reset price path threshold.

> *42. We are also extremely concerned at the results of Meyrick 2007, which updates the relative productivity analysis by extending it to 2006, correcting for known data errors and running a sensitivity test using EDB capital specific shares. This sensitivity uses capital shares derived from EDB specific 2004 ODV asset data, whereas Meyrick 2003 used assumed average capital shares for each of the four density groups noted above. The difference between the assumed group averages and EDB specific shares are material for some EDBs. Meyrick 2007 summarises the sensitivity test as follows:*

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[4] Commerce Commission, Further Work on the Reset DPP for EDBs, Updated Process Paper, 3 May 2010
[5] PwC, Submission on the Threshold Reset 2009 Discussion Paper, 18 February 2008
[6] Commerce Commission, Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Reset 2009, Discussion Paper, 19 December 2007

"For around half the EDBs there are only minor changes in rankings indicating that the group average shares used previously were good proxies and the move to "unoptimising" some underground cables has not had a major effect. For the other half of the EDBs there have, however, been significant changes." [7]

43. We challenge the conclusion that suggests the earlier proxies were reasonable when the productivity rankings of half of the EDBs are significantly affected by using actual as opposed to assumed data. Had the assumed group averages been in line with actual capital shares, the following significant changes to the C_1 and X factors would have occurred.

EDB	C_1 (2003 Analysis)	C_1 (Revised 2003 Analysis)	Impact on X Factor
Centralines	1	0	-1
Electricity Invercargill	-1	1	+2
MainPower	1	0	-1
Nelson Electricity	-1	1	+2
Network Waitaki	0	-1	-1
Orion New Zealand	0	1	+1
The Lines Company	1	-1	-2
Top Energy	0	-1	-1
Vector	-1	1	+2

44. At the time the 2003 analysis was undertaken actual revaluation data was not available and estimates had to be made. However, had the assumptions been more in line with reality, different X factors would have been derived for the 9 EDBs listed above (all other things being equal). This equates to one third of the industry. For four of these EDBs the change would have been equivalent to +/-2% on the X factor which has applied for five years from 1 April 2004. This brings into question the relative weightings of the inputs and outputs and the sensitivity of the MTFP results to these weightings.

45. The revised analysis also has the effect of moving the three high density underground networks into the lowest productivity group. We are not in a position to debate the relative weightings and other input assumptions in detail at this point in time, however we are extremely concerned at the robustness of the approach and its ability to generate reasonable outcomes. This also raises the question of whether the X factors derived for 2004 – 2009 were fair.

[7] *Meyrick 2007, page 26*

18. This illustrates the dangers of proceeding with regulatory decisions which may be based on poor analysis or flawed data. The implications of the imperfections in the data which was used to determine the price paths for the nine EDBs listed above were significant. Had correct data been used, the X factors (which applied from 1 April 2004 – 31 March 2010) would have been different, and in a number of instances significantly different. The cumulative impact of this difference over the six year period has been material to those businesses.

19. We appreciate the Commission is not intending to use (and in fact is prevented from using) this same approach to the DPP reset. However we believe the proposed starting price adjustment methodology which is also data intensive has the potential to generate similar anomalies if it is implemented too quickly without robust testing of the source data, and the analytical methods and outputs.

20. We have previously submitted that the proposed timetable does not allow sufficient time for EDBs to apply the IMs before the information request is made. In the absence of information disclosure requirements which are consistent with the IMs we believe this may be difficult for EDBs to achieve in a robust and timely manner. Our experiences in 2008 showed how much effort is required in developing information requirements of this nature, and the draft determinations are not the equivalent of these. We have also previously noted that some of the IM options being considered will be quicker to implement than others (for example options for opening RAB and common cost allocations).

21. We therefore submit that the Commission should reconsider its proposed timetable for the initial starting price adjustments, in accordance with the ENA submission's recommendations.

22. In the following sections we consider each of the components of the proposed methodology.

Normalised Historical ROIs

23. There is little information in the Discussion Paper on how historical ROIs are to be established and normalised. As the Discussion Paper does not distinguish between the reset to be made in the existing DPP and future DPPs it is not possible to comment on the reasonableness of the proposed methodology. Accordingly we request that further information is provided to interested parties for consideration before the Commission proceeds with its planned information request.

24. It is inferred the ROIs for the initial starting price adjustments will be those pertaining to the 2009/10 year and that these will be derived on a basis consistent with the IMs for at least one and possible more years. The Discussion Paper provides an illustrated example using 2008/09 EDB data however it is stated that this will be updated.

25. In addition the Discussion Paper provides no explanation as to how the Commission has reached its conclusion that historical ROI data is consistent with the Section 53P(3)(b) requirement for starting prices to be determined using current and projected profitability. There is no description of alternative options which have been considered in this respect. If starting price adjustments are made at 1 April 2012, and if 2009/10 ROIs are used to determine current profitability (with some normalisation for historical one off events), the Commission presumably has concluded that this meets the intention of Section 53P(3)(b) for current profitability. It is not clear to us why this would necessarily be the case.

26. It may be that current profitability can be estimated using historical ROIs, however absent the Commission's rationale it is difficult to comment further. Also given the impending IM determinations, we do not fully understand how the Commission proposes to integrate the IMs into the dataset to be used for this purpose.

27. It is also not clear how the proposed normalisation will be undertaken although there is some reference to explanatory notes which may be included in information disclosures. In principle we agree that should historical ROIs be used for this purpose, they need to be adjusted to ensure they provide an estimate of (at least) current profitability and possibly also projected profitability.

28. We are concerned at the potential discretion which may be available to the Commission in undertaking this step in the methodology. The Discussion Paper includes no criteria that would be applied, or indication at the period of time that would be considered or how the normalisation would be implemented in practice. We submit that more information is required on this component of the proposed methodology, as the current proposition is potentially subject to Commission discretion, is not framed in a way in which we can adequately respond to it, and therefore is inconsistent with good regulatory practice.

29. The second part of Section 53P(3)(b) requires starting prices to be assessed with reference to projected profitability. It is proposed that the methodology would address this as follows:

- By using a forward looking WACC estimate;
- By estimating a ROI band to account for historical and future uncertainties in profitability; and

- The DPP design allows for future efficiency gains to be retained throughout the DPP period.

30. Only the second point is unique to the Discussion Paper, as the first and third points have been addressed in the draft IMs, and the DPP provisions included in Part 4. We agree that the first and third points are consistent with providing for projected profitability. However they are not sufficient if historical ROIs are to be used for profitability assessments. We address the second bullet point below.

WACC Estimate

31. We agree that the WACC estimate to be used should be consistent with the cost of capital IM. We note that the draft IM recognises the inherent uncertainty in estimating WACC and proposes that for the purpose of a DPP a WACC estimate at the 75th percentile of the vanilla WACC range will be used. We support a WACC estimate above the 50th percentile, however we refer the Commission to our submission on the cost of capital IM in this respect. We suggest that this component of the proposed methodology cannot be progressed any further until the Commission has considered all of the submissions received on the cost of capital IM and formed its final view.

ROI Band

32. The ROI band is intended to provide for uncertainty in estimating current and projected profitability for each EDB. It is intended that the ROI band will be symmetrical around the forward looking WACC estimate, thus providing a dead band of equal size either side of the WACC estimate. The main role of the band is to assist the Commission to transform historical ROIs into estimates of current and projected profitability, and allow for the inherent uncertainty in this.

33. Once again there is little information in the Discussion Paper about how this will be determined in practice, and the potential issues for the current DPP (given the historical dataset which is currently available) are not addressed.[8] The worked example refers to 'further examination of the consistency of the data' and 'further scenario analysis' without including specifics.[9] This suggests that at the very least the Commission needs to publish a further consultation on the proposed methodology before the process reaches draft decision stage.

[8] For example the disjoint in the EDB disclosure dataset from 2008 onwards.
[9] Discussion Paper, paragraph 6.20

34. The Commission intends to use some discretion in its proposed methodology, which is to determine the ROI band using statistical assessments of the variation in the components of the ROI statistic. For example:

- The Commission considers that it is only necessary to consider variability in opex in assessing the ROI band; and
- It is intended that the outputs of the statistical assessment will not be applied mechanistically and the Commission may cap the limits based on other information.

35. We are not persuaded by the assessment that opex is the closest relevant indicator of ROI variability nor the explanation that revenues cannot be considered because they are affected by the pricing decisions of generators, lines businesses and retailers which cannot be disentangled. Revenues are directly influenced by demand and economic activity, distribution policies and pricing structures for lines charges, as well as recovery of pass through costs. They include distribution use of system charges, transmission use of system charges, discounts and rebates and capital contributions. Year on year variations in them are passed directly to ROI. We submit they cannot be ignored and we do not accept that generator and retailer behaviour is sufficient reason to ignore them.

36. We are also concerned at the proposal to undertake statistical analysis and then potentially ignore it. This approach is inconsistent with good regulatory practice and provides the Commission with too much discretion. It is also inconsistent with the intention of Part 4 to provide certainty for regulated suppliers and consumers.

Lower Limit of ROI Band

37. If an ROI band is to be used to adjust historical ROI performance in order to assess current and future profitability, we do not accept that the lower band should fall below the WACC estimate to be determined in accordance with the cost of capital IM. Currently the draft decision is that the WACC estimate will be set at the 75th percentile of the WACC range, to account for the inherent uncertainty in assessing WACC. We agree that the WACC estimate should be set above the 50th percentile for this reason.

38. Accordingly, we submit that the lower end of the ROI band should be set equal to the cost of capital IM, where the WACC estimate is set to account for uncertainty. To impose regulated prices below this would be inconsistent with the Section 52A purpose statement as it would prevent EDBs from having sufficient incentives to invest and innovate (consistent with subpart (a) of Section 52A). Therefore such EDBs would also be unable to have sufficient incentives to improve efficiency and provide services at a quality that reflects consumer demands, consistent with subpart (b) of Section 52A.

39. Further subpart (d) and Section 52A requires the regulatory regime to limit the ability of suppliers to extract excessive profits. By setting prices below the WACC estimate, the Commission will be limiting the ability of suppliers to earn normal profits. Therefore we do not agree that the ROI band must be symmetrical.

40. For the avoidance of doubt, we believe an upper band is necessary in order to meet the Section 53P(3)(b) requirements to set starting prices with reference to current and future profitability where the base data to be used is historical ROIs.

Adjusting Prices to the Band

41. Consistent with our submission above, should the Commission implement its proposed methodology for starting price adjustments any EDB with normalised ROI which falls below the WACC estimate should have their DPP price path raised to produce prices equivalent to the WACC estimate. This will impact all EDBs which fall below the WACC estimate (including those which currently fall within the lower half of the Commission's proposed ROI band and for which no price adjustments are proposed in the Discussion Paper).

42. For EDBs with normalised ROI estimates which fall between the WACC estimate and the upper limit of the ROI band we agree with the proposal that no adjustments will be made. Further increases in profitability are available under the DPP consistent with the efficiency incentives in the Purpose Statement. Any efficiency incentives which are made and which allow an EDB to remain within this upper band, can be retained into the next DPP period, which we support.

43. For those above the upper ROI band it is proposed that the DPP price path is reduced. Paragraph 3.15 of the Discussion Paper sets out a complicated process for making this adjustment which we submit is unnecessarily complex. It should be possible to infer from the analysis to be undertaken a percentage reduction in revenue required to meet the ROI band (similar to that presented in Figures 6.2 and 6.3 of the Discussion Paper). The same percentage reduction can be applied to the Allowable Revenue that would otherwise have been included in the DPP in the year in question (ie: the year that the adjustments are to be made) to achieve the outcomes sought by the adjustment process. This simply assumes that weighted average price reductions are applied equally to all consumers consistent with the ROI band target. This is acceptable as the DPP does not attempt to regulate individual tariffs, and nor should it.

Discounts and Rebates

44. The Discussion Paper does not address how EDBs which make discretionary discounts or rebates will be assessed. Our submissions on the regulatory tax IM and the cost of capital IM raised a number of points in this respect. On particular we have submitted that:
    - Regulated revenues should be assessed after discretionary discounts are deducted to ensure they reflect the prices paid by consumers for regulated electricity lines services; or
    - If this adjustment is not made, the tax effect of the discretionary discounts needs to be added back to the regulatory tax allowance to ensure regulated revenues and regulatory tax are assessed on a consistent basis; or
    - If neither of these adjustments is made, for those EDBs with discretionary discounts included in regulated revenue, the WACC estimate used to assess their ROI performance must be altered otherwise the cash flows for those entities are inconsistent with the WACC.

45. We also note that the proposed ROI band approach provides incentives for EDBs to move above or below the band using their discount mechanisms. Accordingly, we submit that the Commission can only address these potential anomalies by assessing the net prices paid by consumers after the deduction of all discounts or rebates. To do otherwise will only lead to potentially perverse results.

Treatment of Efficiencies

46. The discussion in Section 5 of the Discussion Paper on efficiency incentives is somewhat premature given the recent consultation on IMs. Our submission on the processes and rules IM proposed that the Incremental Rolling Incentive Scheme (IRIS) should be implemented in the DPP and well as the CPP and should be extended from five years to ten years. The Discussion Paper has been prepared consistent with the Draft IM which does not reflect consideration of submissions.

47. We agree in principle for efficiencies to be recognised in the DPP and propose that a carry-over mechanism is introduced similar to IRIS for this purpose. We also submit that merger and acquisition expenses should be included as expenses in the ROI assessment consistent with the requirement to incentivise investment in innovation and provide incentives for efficiency gains.

48. We do not support the Discussion Paper's proposal that efficiencies earned within the DPP period would be fully passed on at the end of the period, where they result in ROIs above the upper band. This period is too short, and in practice five years would only be achieved if the efficiencies were made on the first day of the DPP period.

General

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