Aurora Energy Limited

Submission to the Commerce Commission

on its

Discussion Paper

on

Starting Price Adjustments

for

Default Price-Quality Paths

10 September 2010

Executive Summary

The Commerce Commission reset the Default Price-quality Path (DPP) for non-exempt electricity distribution businesses on 1 April 2010. The regulatory period for the reset DPP extends from 1 April 2010 to 31 March 2015. At the time of this reset, the Commission stated its intention to make starting price adjustments once the relevant Input Methodologies had been determined. Starting price adjustments will likely take effect from 1 April 2012.

On 5 August 2010, the Commission published a *Discussion Paper* setting out its proposals for determining starting price adjustments, and is seeking submissions from interested parties.

Aurora's submission makes the following points for consideration by the Commission:

- the statutory framework only allows the Commission to reset the DPP (using starting price adjustments) on the basis that Input Methodologies will result in a materially different DPP;
- the upper bound of the proposed 'ROI Band' needs to be increased to provide incentives for investment and innovation;
- the WACC itself is too low, given current financial market conditions, and needs to be increased to provide incentives for investment and innovation;
- the Commission's proposals for projected profitability are not forward looking; and
- arguably, the manner in which the Commission proposes to undertake starting price adjustments will result in past profits being clawed back, which is in contravention of the statutory framework for DPPs.

In summary, Aurora's primary concern is the Commission's proposal to use historical profitability as the basis for setting future prices. This is inconsistent with the regulatory framework, and is likely to undermine incentives for investment, innovation, and ongoing efficiency. On this basis the Commission is unlikely to achieve outcomes consistent with workable competition. The Commission's proposals are therefore not optimal in promoting the long-term benefit of consumers.

Instead of the Commission's proposals, Aurora regards it as necessary to forecast the projected profitability of EDBs using a qualitative assessment approach. Qualitative assessments would, for example, be informed by the likes of Asset Management Plans and company specific material obtained via the January 2011 information request. The Commission had previously proposed such an approach in its June 2009 preliminary views. Aurora recommends that the Commission reject its current proposals in favour of developing and implementing its preliminary views.

1 Introduction and Background

The Commerce Commission resets the Initial Default Price-quality Path (DPP) for Aurora Energy Limited, and other non-exempt electricity distribution businesses (EDBs), on 1 April 2010 (the *2010 Reset*). The regulatory period for the reset DPP extends from 1 April 2010 to 31 March 2015.

Two key elements of the reset DPP are:

- the starting prices for each EDB; and
- the rate of change in prices (relative to the CPI) for each subsequent year of the regulatory period.

In its final decisions[1] on the *2010 Reset*, the Commission determined that the X-factor (for the CPI-X rate of change in prices) should be zero, and the starting prices were to be the prices a non-exempt EDB charged as at 31 March 2010. However, the Commission also indicated that these starting prices will be reviewed following the publication of Input Methodology determinations. In this regard, the Commission is invoking transitional provisions in the Commerce Amendment Act 2008 that effectively allow starting price adjustments to be deferred until after the determination of relevant Input Methodologies.

Whilst final Input Methodology determinations have not been issued by the Commerce Commission, the process is well advanced. On 5 August 2010, the Commission published, for consultation, a *Discussion Paper*[2] on starting price adjustments to the DPP. The Commission has requested submissions on its *Discussion Paper* from interested parties. The Commission proposes that starting price adjustments will take effect from 1 April 2012.

2 Aurora's Submission on the Commission's Discussion Paper

Aurora welcomes the Commission's *Discussion Paper* on starting price adjustments. In past submissions, Aurora supported the Commission's proposed 'two-step' process for setting starting prices for the *2010 Reset*. In particular, Aurora supported:

- the deferral of potential starting price adjustments until after the determination of Input Methodologies; and, in the interim
- the use of actual prices (as posted by each EDB as at 31 March 2010) as the starting prices under the DPP.

Aurora regarded this 'two step' process as a pragmatic way to reset the DPP at a time when Input Methodologies of direct relevance to efficient pricing were still under development, the world economy was imperilled, economic growth was in decline, and investment capital was increasingly difficult to procure. The proposed 'two step' process:

- enabled these matters to be considered without having to adjust prices twice in the regulatory period; and
- was sufficient to discourage opportunistic price increases by EDBs on or before 31 March 2010.

In this submission, Aurora provides its response to the Commission's *Discussion Paper* and, in particular, highlights fundamental concerns with the Commission's proposals for how it is to effect starting price adjustments.

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[1] Commerce Commission; "Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses: Decisions Paper"; 30 November 2009

[2] Commerce Commission; "Starting Price Adjustments for Default Price-Quality Paths: Discussion Paper"; 5 August 2010 (hereinafter referred to as the *Discussion Paper*)

Aurora also notes that the Electricity Networks Association (ENA) has also prepared a submission on the *Discussion Paper*. Aurora has reviewed, and supports, the ENA submission.

Aurora's submission is relatively brief. As Aurora finds itself disagreeing with the core proposals articulated in the Commission's *Discussion Paper*, this submission seeks to develop a principles based approach for determining starting price adjustments under a DPP. Aurora accepts that further consultation will be necessary to develop these qualitative principles so that starting price adjustments can be quantified.

The remainder of this submission sets out:

- regulatory framework principles;
- principles for determining projected profitability; and
- other related issues.

3 Regulatory Framework Principles

In this section, Aurora sets out the statutory framework governing starting price adjustments for the DPP. This provides the context for any regulatory determination by the Commission on the application of starting price adjustments. From this, Aurora takes the view that the Commission's *Discussion Paper* proposals have not reflected the regulatory framework in its proper context, and as a consequence, the regulatory framework is not being applied correctly.

3.1 Statutory Provisions Relevant to Starting Price Adjustments

The salient provisions of the Commerce Act 1986 (the Act) are as follows:

- *The overall (Part 4) purpose statement (s52A of the Act)*

  52A Purpose of the Part

  (1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services –

  (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

  (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

  (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

  (d) are limited in their ability to extract excessive profits.

- *The DPP is intended to be a 'low cost' regulatory instrument (s53K of the Act)*

  53K Purpose of default/customised price-quality regulation

  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.

- *In resetting the DPP the Commission may make starting price adjustments (s53P of the Act)*

> ***53P Resetting starting prices, rates of change, and quality standards***
>
> *(1) Before the end of the first and every subsequent regulatory period, the Commission must amend the section 52P determination by setting out the starting prices (as referred to in section 53O(a)), rates of change (as referred to in section 53O(b)), and quality standards (as referred to in section 53O(c)) that apply for the following regulatory period.*
>
> *(2) In resetting starting prices, rates of change, and quality standards, the Commission must consult with interested parties.*
>
> *(3) The starting price adjustments must be either –*
>
> > *(a) the prices that applied at the end of the preceding regulatory period; or*
> >
> > *(b) prices, determined by the Commission, that are based on the current and projected profitability of each supplier.*
>
> *(4) Starting prices set in accordance with subsection (3)(b) must not seek to recover any excessive profits made during any earlier period.*
>
> *...*
>
> *(10) The Commission may not, for the purposes of this section, use comparative benchmarking on efficiency in order to set starting prices, rates of change, quality standards, or incentives to improve quality of supply.*

- *Starting price adjustments may be deferred until after the determination of input methodologies (s54K of the Act)*

> ***54K Section 52P determinations setting out default price-quality paths applying from 1 April 2010***
>
> *(1) Before 1 April 2010, the Commission must reset the default price-quality paths for each supplier that apply on and after that date, using the process set out in section 53P.*
>
> *(2) The Commission may reset the default price-quality paths even if all or any of the relevant input methodologies have not been determined.*
>
> *(3) If an input methodology is published after 1 April 2010 and if, had that methodology applied at the time the default price-quality paths were reset as required by subsection (1), it would have resulted in a materially different path being set, then the Commission may reset the default price- quality paths in accordance with section 53P and may apply clawback, despite section 53ZB(1).*
>
> *(4) However, the Commission may not exercise its powers in subsection (3) later than 9 months after the date of publication of the input methodology.*

Aurora contends that the Commission's *Discussion Paper* proposals do not have sufficient regard to the regulatory framework as outlined above. In particular, Aurora has concerns that the context and application of the Commission's proposals are inconsistent with this framework.

3.2 Context of the Regulatory Framework

Starting price adjustments should be seen in the context of:

- the overall statutory purpose for regulatory control (i.e. *... to promote the long term benefit of consumers ... by promoting outcomes that are consistent with outcomes produced in competitive markets ...*[3]).
- the likely impact of existing prices and/or current and projected profitability on:
  - investment and innovation;
  - incentives for improved efficiency and quality;
  - the sharing of efficiency gains with consumers; and
  - limiting excessive profits[4].
- being forward looking rather than retrospective.
- providing a low cost regulatory option.

Aurora accepts that the Commission has had some regard to the overall statutory purpose (s52A), but has taken an overly simplistic view/approach in relation to this. For instance, the Commission states:

> *"The Commission's current views on the starting price adjustment process set out in this Discussion Paper have been reached after taking into account the DPP regulatory framework and the Part 4 Purpose. For example, a downward adjustment to prices may be appropriate – consistent with s 52A(1)(c) and (d) – in cases where suppliers are considered to be earning, or likely to earn, excessive profits and/or to promote the sharing of efficiency gains with consumers. Similarly, upward adjustments may be justified where current prices are likely to be too low to allow a supplier to earn a normal rate of return and facilitate efficient investment – consistent with s 52A(1)(a) and (b)."* [5]

It would appear that the Commission's proposals for starting price adjustments are primarily influenced by ensuring incentives for investment/innovation and limiting excessive profits. It also appears that the Commission affords these regulatory objectives differential weightings (in favour of investment incentives) by constructing a 'ROI Band' that is distributed above and below the WACC point estimate[6].

Arguably, the regulatory objectives listed in s52A(1) (a) to (d) of the Act should not be equally weighted. Along with others[7], Aurora has previously contended that the 2008 amendments to the Commerce Act intended to prioritise incentives for investment and innovation as a regulatory objective. In fact, it may be argued that the regulatory objectives are in fact listed in order of priority – with limiting excessive profits being lower priority than the others. The Commission provides some support to this – for instance:

> *"... where there is potentially a trade-off between dynamic efficiency (i.e. incentives to invest) and static allocative efficiency (i.e. higher short-term pricing), the Commission will always favour outcomes that promote dynamic efficiency. The reason being that dynamic efficiency promotes investment over time and ensures the longer term supply of the service, which thereby promotes the long-term interests of consumers."* [8]

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[3] Refer to s52A of the Act

[4] These being the 'regulatory objectives' listed in the Part 4 purpose statement (as provided in s52A(1)(a) to s52A(1)(d) of the Act).

[5] refer to *Discussion Paper*, para 2.13

[6] Where the 75th percentile of the WACC range is used as the WACC point estimate

[7] For instance, refer to Vector; "Submission in response to the Commerce Commission's Draft Reasons Paper for Electricity Distribution Businesses and Gas Pipeline Businesses: Asset Valuation"; 23 August 2010; paras 25-27

[8] Commerce Commission; "Input Methodologies – Electricity Distribution Services: Draft Reasons Paper"; 18 June 2010; p 315 (para 6.12.52)

"The Commission places significant weight on dynamic efficiency in comparison to the other dimensions of efficiency, given the importance of efficient investment to the long term benefits of consumers. This is because, over time, under-investment increases the risk that a lines business may not be able to continue to provide services at a quality that reflects consumer demands. The importance of dynamic efficiency is also emphasised in the recent GPS, which concerns the incentives of regulated businesses to invest in infrastructure ... In particular, the GPS highlights the importance of regulatory stability, transparency and certainty for giving businesses the confidence to make long-lived investments ...

... it could be consistent with the Purpose Statement—and with the regulatory stability and certainty objective of the GPS—for the Commission not to control prices to a lower level. Such might be the case even if profits were to exceed the business's WACC range over the short term. ***This is because the price path threshold is intended to limit excessive profits, not to remove them entirely*** *...*

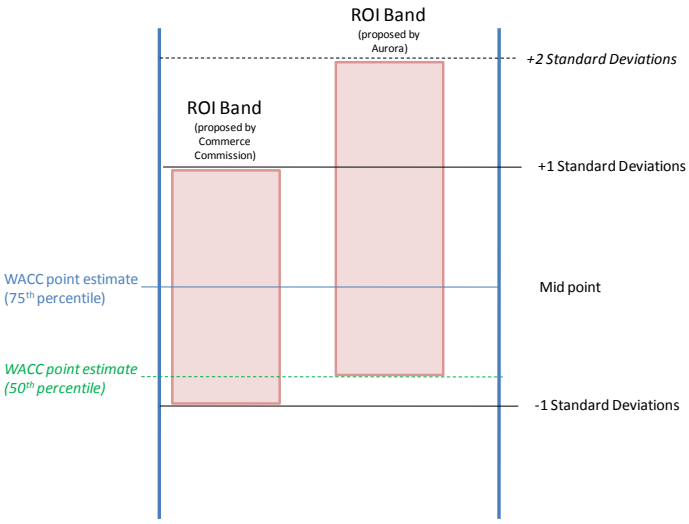
... businesses have an incentive to outperform the efficiency gains implied by their price path threshold because, throughout the five-year regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their CPI-X price path. Allowing a distribution business to retain this higher level of returns also preserves the incentives for that business to make ongoing efficiency gains in subsequent periods.

As a result, consumers will benefit more because the level of efficiency gains available to be shared over subsequent regulatory periods ... will be greater. Therefore, the long-term efficiency benefits to the consumers supplied by that business might outweigh any additional short-term benefits which could be realised by those consumers if controlled prices were lower than the existing price path threshold levels.

On the other hand, requiring profits to be shared more immediately than that implied by a business's X factor (i.e., before the end of the current regulatory period) may in some circumstances risk dampening future incentives for that business to invest and improve efficiency, thereby potentially reducing benefits to consumers in the longer term ..." [9] [emphasis added]

This latter quote was in the context of the Unison Control Inquiry under the former Targeted Control (i.e. Thresholds) Regime—which has now been repealed. However, the legislation in effect at that time included similar regulatory objectives, including the limiting of excessive profits.

Whilst, in providing a 'ROI Band' around the WACC point estimate, the Commission has had some regard for the priority of the s52A regulatory objectives, Aurora does not regard this as sufficient. In Aurora's view the upper-bound of the 'ROI Band' should be higher, and the lower-bound should be set at least at the level of the 50th percentile of the WACC range, in order to provide appropriate incentives for investment and innovation. This is illustrated in the adjacent diagram:



[9] Commerce Commission; "Regulation of Electricity Lines Businesses – Targeted Control Regime – Reasons for not Declaring Control – Unison Networks Limited"; 11 May 2007; pp 45-46

Aurora's rationale for an upwards shift in the 'ROI Band' is as follows:

- *In only/partly accounting for ROI variability, the 'ROI Band' is too narrow to provide incentives to invest*

  - The 'ROI Band' is to account for the uncertainty in a point estimate of supplier returns. The Commission cites a variability in historical 'returns'[10] of between 1% and 1.25%. As a consequence, the Commission has used +/- 1% and +/- 1.25% for the dead band in the illustrative examples presented in the *Discussion Paper*. Aurora has two concerns with this.

    First, it is noted that the dead band is intended to account for ROI variability in the sense that a particular ROI may not reflect future ROI. In other words, an actual ROI at the top of the ROI Band may reflect a future ROI equal to the WACC point estimate (with the probability associated with 1 standard deviation). As an *ex ante* expectation, this outcome does not provide (strong) incentives for investment. Aurora argues that an additional margin is necessary to provide these incentives. Without trying to be overly mechanistic, Aurora suggests that a 2 standard deviation dead band would be more consistent with the prioritisation of the regulatory objectives (as illustrated in the above diagram). A single standard deviation band is more appropriate in circumstances where the Commission has explicitly calculated 'projected' returns—for example by way of a partial building blocks approach.

    Second, the Commission's assessment of the standard deviation in a supplier's returns is based on operating expenditure variability. Operating expenditure is only one factor driving an EDB's ROI. The Commission suggests that accounting for other factors, such as revenue, will entangle the ROI with extraneous factors. For instance:

    > "*The Commission's analysis also does not rely on variations in revenue as variations are driven by demand for electricity which is affected by the pricing decisions by generators, lines businesses and retailers, and the Commission does not have sufficient information to disentangle these effects.*" [11]

    Aurora regards this as false logic, as, notwithstanding their causality, these factors affect the returns reported by EDBs.

- *The WACC, as specified, is below reasonable expectations and therefore too low to incentivise investment*

  - The 75th percentile of the WACC range has been identified as recompense for parameter uncertainty in determining an estimate for the cost of capital[12]. The Commission also suggests that an estimate above the mid-point is used to account for social asymmetry where the cost of underestimating the cost of capital is likely to outweigh the costs of overestimation[13]. The choice of the 75th percentile is therefore not a strong basis to argue that the Commission has sought to account for any differential in the weighting of the regulatory objectives.

  - Moreover, it is Aurora's view that the WACC point estimate provides a manifestly inadequate estimate of Aurora's cost of capital in the present financial climate. In this regard, Aurora believes that much of the pragmatism that surfaced at the Commission's Cost of Capital Workshop has been lost in the Commission's draft reasons[14]. For instance, the Commission refers to a December 2009 decision by Ofgem not to increase its estimate for the Market Risk Premium (MRP) because *the cost of equity had returned to normal levels*[15]. Such sentiments are entirely premature, and Aurora points out that since December 2009 markets have had to contend with a Eurozone financial crisis (centred on Greece), and other ongoing market volatility

[10] By calculating the standard deviation of the ratio between operating expenditure and the RAB (from 2002/03 to 2006/07).
[11] refer to *Discussion Paper*, para 6.17
[12] Commerce Commission; "Input Methodologies – Electricity Distribution Services: Draft Reasons Paper"; 18 June 2010; p 314 (para 6.12.49)
[13] Ibid, p 315 (para 6.12.52)
[14] Commerce Commission; "Input Methodologies – Electricity Distribution Services: Draft Reasons Paper"; 18 June 2010
[15] Ibid, p 276 (para 6.8.84)

that cannot be regarded as steady-state or normal. Aurora also notes that the AER has increased its estimate of the MRP (from 6% to 6.5%) following the *Global Financial Crisis*, and maintained it.

Aurora notes that these concerns would (to some extent) be addressed if the Commission were to increase its estimate of the cost of capital as has been recommended by EDBs in their response to the Commission's draft reasons.

- *A higher upper bound for the 'ROI Band' will support a broader range of regulatory objectives*
  - In addition to ensuring incentives for investment/innovation and limiting excessive profits, the regulatory objectives require incentives for efficiency and quality. Aurora has previously advocated an efficiency carryover mechanism (ECM) for both the DPP and the Customised Price-quality Path (CPP). In the absence of a formal ECM for the DPP, a higher upper bound for the 'ROI Band' will provide the ongoing incentive that an ECM typically provides—in a low cost manner consistent with the DPP, and also consistent with the sharing principle.

The regulatory framework also provides that starting price adjustments should be undertaken in a non-retrospective context. In particular, where the Commission determines not to retain existing prices as the starting prices, then any adjustment must have regard to current and projected profitability. This requires a forward looking approach. Aurora strongly contends that the Commission's proposals are not forward looking. In fact, Aurora regards the Commission's approach as allowing the recovery of past profitability—which is not permitted under the DPP. As Aurora's concerns in this area are fundamental, this issue is addressed more fully in Section 4 below.

Finally, Aurora notes that the Commission's proposals to use 'past' profitability as a basis for projected profitability is not consistent with a low cost DPP. Whilst at first sight, the Commission's proposal is arguably 'simple' and therefore low cost in nature, Aurora notes that this approach may in fact force an EDB into a CPP. This would be an undesirable consequence that potentially could have been avoided through a more judicious assessment of projected profitability (e.g. through the use of a low cost partial building blocks assessment). Aurora understands that a CPP is intended for use where an EDB's 'special circumstances' are not easily accommodated by a generic DPP.

3.3 Application of the Regulatory Framework to Starting Price Adjustments

As noted previously, Aurora considers that the Commission's *Discussion Paper* proposals do not have sufficient regard for how starting price adjustments should be applied. There are two key areas of concern for Aurora. First, the Commission has not justified the need for starting price adjustments, and secondly, the Commission is yet to demonstrate that the use of input methodologies in determining starting price adjustments will have a material effect on the DPP.

- *Justification for starting price adjustments*

  In resetting the DPP, the Commission has the option of: retaining the prices that applied at the end of the previous regulatory period (in this case, prices that applied at 31 march 2010); or, resetting prices using current and projected profitability as a basis for that decision.

  53P Resetting starting prices, rates of change, and quality standards

  ...

  (2) In resetting starting prices, rates of change, and quality standards, the Commission must consult with interested parties.

  (3) The starting price adjustments must be either –

  (a) the prices that applied at the end of the preceding regulatory period; or

  (b) prices, determined by the Commission, that are based on the current and projected profitability of each supplier.

Aurora recognises that the Commission has discretion as to which of these options it adopts for resetting the DPP. However, s53P of the Act requires the Commission to consult with interested parties. Aurora believes that this should include consultation on whether starting price adjustments are necessary (especially in relation to promoting the outcomes and regulatory objectives set out in s52A of the Act).

The Commission notes that:

> "*The Act provides that the Commission must specify the starting prices for each supplier based on either: (i) the prices that applied at the end of the previous regulatory period, or (ii) those based on an assessment of the current and projected profitability of that supplier. This paper focuses on the process for specifying starting prices in accordance with the second of these options.*" [16]

The Commission also notes that:

> "*On 30 November 2009, the Commission published the s 52P determination and its decisions for the DPP applying to EDBs from 1 April 2010. Starting prices were specified as the actual prices that a non-exempt EDB applied at 31 March 2010. The Commission stated its intention to adjust these starting prices during the regulatory period, following the publication of IMs.*" [17]

Aurora, along with other EDBs, supported the Commission taking this approach. However, Aurora's primary motivation was to avoid the possibility of prices being reset twice. The Commission's motivations included ensuring prices provided sufficient incentive for investment whilst limiting excessive profits and discouraging non-justified increases in prices on (or before) 31 March 2010. The Commission also justifies starting price adjustments as being necessary to take into account the specific circumstances of suppliers/EDBs. For instance:

> "*A DPP may not be able to fully reflect the particular circumstances of a supplier as its low-cost, generic nature means that it is a comparatively non-targeted regulatory instrument. Given a DPP employs an industry-wide annual rate of change, starting price adjustments are the primary regulatory mechanism for making the price related aspects of a DPP more specific to individual suppliers. ...*" [18]

Whilst not disagreeing with these sentiments, Aurora notes that the regulatory framework also provides for the rate of change (X-factor) to be tailored to address financeability or price shock concerns that may arise in relation to the prices of a particular EDB.

In short, Aurora does not regard the Commission, in its consultation to date, to have made a sufficient case (especially one based on the outcomes and regulatory objectives set out in s52A of the Act) for adjusting starting prices. As noted above, the Commission has reset the DPP using existing prices (notwithstanding its intent to instigate starting price adjustments). Its only opportunity to reset starting prices—on the basis of current and projected profitability—is if the yet-to-be-determined Input Methodologies would result in a materially different path being set (as per s 54K of the Act). If this is the case, the Commission may reset the DPP in accordance with section 53P. In so doing, Aurora expects that the Commission would consult with interested parties, and would use this consultation to justify the need to adjust starting prices.

[16] refer to *Discussion Paper*, para X.2
[17] refer to *Discussion Paper*, para 1.11
[18] refer to *Discussion Paper*, para 2.12

- *Demonstrating the use of input methodologies will have a material effect on the DPP*

  Following the determination of key Input Methodologies by the Commission, it may have grounds to re-invoke s53P of the Act, and give effect to starting price adjustments. The salient legislation is found in s54K.

  > ***54K Section 52P determinations setting out default price-quality paths applying from 1 April 2010***
  >
  > *(1) Before 1 April 2010, the Commission must reset the default price-quality paths for each supplier that apply on and after that date, using the process set out in section 53P.*
  >
  > *(2) ...*
  >
  > *(3) If an input methodology is published after 1 April 2010 and if, had that methodology applied at the time the default price-quality paths were reset as required by subsection (1), it would have resulted in a materially different path being set, then the Commission may reset the default price- quality paths in accordance with section 53P ...*

  In Aurora's view, starting price adjustments can only be invoked if relevant Input Methodologies (once determined) were to give rise to *a materially different path being set*. The onus is on the Commission to show that this is the case.

4 Principles for Determining Projected Profitability

In this section, Aurora sets out its fundamental concern that the Commission's *Discussion Paper* proposals for adjusting starting prices do not have sufficient regard to future profitability projections. These concerns are premised on the assumption that the Commission is to adjust starting prices using current and projected profitability—pursuant to s53P(3)(b) of the Act.

To address its concerns, Aurora provides recommendations as to how the Commission's proposals can be modified / improved to better achieve the regulatory purpose.

In Aurora's view, uncertainty prevails as 'projected profitability' is not defined, and neither is it currently intended to establish, as an Input Methodology, the 'process' for determining starting price adjustments. This is unfortunate, as in the future there will be the same uncertainty over resetting key elements of the price path as currently is the case.

4.1 Outline of the Commission's Approach to Starting Price Adjustments

The Commission's approach to undertaking starting price adjustments may be summarised as follows[19]:

i. Calculate the supplier's returns ... using ROI statistics and other information

ii. Assess the supplier's profitability ... by comparing the supplier's returns against an industry-wide 'ROI Band' that is centred around the WACC point estimate (currently the 75th percentile of the vanilla WACC range)

[19] refer to *Discussion Paper*, paras 3.7 – 3.8

iii. Determine if a supplier's returns are above or below the 'ROI Band' and calculate the percentage difference with respect to the relevant limit of the 'ROI Band' (ROI differential) ... an upward or downward adjustment would be considered if a supplier's returns were below or above the 'ROI Band' respectively. The Commission considers that it is appropriate for any adjustment to be limited to the relevant 'ROI Band' limit (i.e., any downward adjustment would be down to the upper limit and any upward adjustment would be up to the lower limit)

iv. Translate the ROI differential into an adjustment to supplier's actual weighted average prices or revenues for the specified year.

This differs from the preliminary view expressed by the Commission in June 2009[20]. In this preliminary view, it was the Commission's intention to also include a qualitative assessment of certain scenarios that could be expected to impact on an EDB's projected profitability. Aurora indicated its broad support for the Commission's proposed use of a qualitative assessment process, and further notes that a qualitative assessment involving a low cost partial building blocks process would be consistent with this.

It now appears that the Commission regards the qualitative assessment of an EDB's projected profitability to be a matter that is best considered in the context of a CPP proposal. Further, the Commission suggests that qualitative assessments would require detailed information from EDBs which would tend to be inconsistent with the low cost nature of the DPP. In addition, the Commission notes that capital and operating expenditure forecasts utilised in qualitative assessments are unlikely to be subject to rigorous/independent verification under a DPP—and this may lead to outcomes that are not in the long-term interests of consumers.

Where an EDB's future expenditure requirements differ significantly from those implied by its starting prices, the Commission suggests that a CPP proposal may be the best approach for that EDB.

4.2 The Commission's Approach is not Forward Looking

The Commission recognises the need for starting price adjustments to be based on both current and projected profitability[21]. Whereas a typical approach to determining projected profitability would involve forecasting/estimating future revenue and expenditure cash flows along with the asset base, the Commission's approach is quite different. To determine projected profitability the Commission takes an estimate of an EDB's 'normal'/expected profitability and then, using the historical variability of EDB returns, identifies a statistical range (the 'ROI Band') in which future profitability is likely to exist. To determine whether a starting price adjustment is needed, the Commission simply identifies where an EDB's current (i.e. latest) profitability sits with respect to the 'ROI Band'. Where current profitability falls outside the 'ROI Band' a starting price adjustment is made.

Given that there is no definition of, or defined process for determining projected profitability, the Commission regards its approach to be as valid as any alternative. Moreover, the Commission notes that the WACC, which is used as a basis for an EDB's expected profitability, is a forward looking metric that applies for the duration of the regulatory period. The Commission regards the combined use of the WACC and the 'ROI Band' to be consistent with taking into account projected profitability.

However, Aurora contends that the Commission's proposed approach is not forward looking. Instead, Aurora believes the Commission's approach to be tantamount to a retrospective 'rate of return' control. No matter how the Commission chooses to 'dress up' the proposed approach, it remains the case that the Commission is estimating an EDB's projected profitability using (normalised) historical data.

[20] Commerce Commission; "Reset of Default Price-Quality Path for Electricity Distribution Businesses - Discussion Paper"; 19 June 2009

[21] refer to *Discussion Paper*, para 3.17

Given that the Commission would be unlikely to sanction the use of an historic WACC (where a forward looking WACC estimate were available), Aurora finds it difficult to understand why the Commission would sanction the use of an historic-based estimate of projected profitability—where a forward looking estimate could also be derived relatively easily.

As identified previously, the Commission is concerned with the veracity of forward looking expenditure projections. However, the Commission has indicated that it does not intend to be overly mechanistic in its determination of projected profitability, and that other information may be referenced by the Commission in its assessments[22]. Aurora regards the use of forward looking profitability projections to be more robust than the use of historic variances to provide a range for future profitability. Given the Commission's intention to avoid being mechanistic, there would appear to be a place for qualitative assessments (as per the Commission's preliminary views in June 2009).

4.3 Dealing with Uncertainty

As identified previously, there is considerable uncertainty with respect to staring price adjustments—and how they may be implemented for the *2010 Reset* and for future resets of the DPP. Uncertainty over regulatory outcomes tends to undermine investment. Input Methodologies, provided for by the amendments to the Act in 2008, were intended to provide greater regulatory certainty.

Aurora is aware of the correspondence between ENA and the Commission on an Input Methodology addressing starting price adjustments. The *Discussion Paper* alludes to this as follows:

> "*Input methodologies that apply to EDBs, GTBs and GDBs may be relevant to informing the Commission's assessments in respect of starting price adjustments. In some cases, IMs will directly impact on the starting price adjustment process. More generally, information that is prepared consistent with IMs may provide useful inputs for the starting price adjustment process, particularly inputs to the Commission's assessment of regulated suppliers' profitability.* ***The Commission considers that the starting price adjustment process is relevant to the determination of a DPP and is not required to be an IM in itself***." [23] [emphasis added]

In past submissions on the *2010 Reset* and on the determination of Input Methodologies, Aurora has suggested that the Commission develop 'process' Input Methodologies relating to matter such as:

- assessing profitability;
- assessing productivity; and
- efficiency carryover.

Potentially all of these would constitute Input Methodologies (e.g. as regulatory processes) under a liberal interpretation of the Act. Aurora suggests that it is not within the spirit of the Act to leave the DPP 'uncertain'. In addition, it is not within the spirit of the Act to force EDBs towards a CPP in order to obtain certainty over outcomes. Section 52R makes it clear that Input Methodologies are to give certainty to all regulation under Part 4. Aurora, however, recognises that the Commission is unlikely to take this broad and liberal interpretation in the case of matters falling under its discretion. In this regard, Aurora finds it anomalous that the Commission has established an Input Methodology for efficiency carryover (i.e. the IRIS[24]) but argues that an Input Methodology relating to the starting price adjustment process is not required.

[22] refer to *Discussion Paper*, para 4.20
[23] refer to *Discussion Paper*, para 2.18
[24] Incremental Rolling Incentive Scheme

In the case of assessing productivity, the Commission adopted a non-mechanistic approach, and took into account the views of other parties when determining the X-factor. Aurora assumes that the Commission will adhere to this approach at the next reset—so as to provide greater certainty for EDBs at the next DPP reset (in the absence of an Input Methodology).

Similarly, in the case of assessing current and projected profitability, the Commission also indicates that it will adopt a non-mechanistic approach. For instance:

> "*Historical variations in these components may also assist in informing the degree to which suppliers' actual ROI from any given year might be an appropriate returns measure for the profitability assessment. The Commission considers that it would not be appropriate to mechanistically apply the results of such quantitative analysis.*" [25]

The Commission has made it clear that it does not intend to establish an Input Methodology for projected profitability. Aurora notes that this was also the case in the Commission's determination of the X-factor. Accordingly, Aurora expects that the Commission will take into account the views of Aurora, and other parties, in determining starting price adjustments in a non-mechanistic manner.

4.4 Aurora's Proposals – The Way Forward

Aurora's key concerns with the *Discussion Paper* proposals are:

- retrospectivity;
- not forward looking; and
- the treatment of capital expenditure.

Each of these is addressed below.

- *Retrospectivity*

  The Commission's regard for current and historic profitability when determining starting price adjustments is likely to give rise to the retrospective recovery of past profits (including excessive profits) as a proxy for limiting excessive profits in the future. Pursuant to s53P(4) of the Act, the Commission must not seek to recover any excessive profits made during an earlier period. Arguably, the Commission's proposals will contravene this statutory provision.

- *Not forward looking*

  The Commission's regard for current and historic profitability when determining starting price adjustments will be biased towards past factors and economic conditions that influenced an EDB's returns. As proposed, the Commission's determination of starting price adjustments gives little weight to what may happen in the future. This is not just important to individual EDBs (in the case of EDB specific factors), but has industry-wide connotations as well. For instance, setting starting price adjustments on the basis of current and historic profitability at the peak of an economic cycle will potentially overstate the profitability projections for the next regulatory period.

  Aurora notes the following comments from the Commission:

  > "*A DPP may not be able to fully reflect the particular circumstances of a supplier as its low-cost, generic nature means that it is a comparatively non-targeted regulatory instrument. Given a DPP employs an industry-wide annual rate of change, starting price adjustments are the primary regulatory mechanism for making the price related aspects of a DPP more specific to individual suppliers. ...*" [26]

[25] refer to *Discussion Paper*, paras 4.19 and 4.20
[26] refer to *Discussion Paper*, para 2.12

If this is the case, and ignoring the ability to adjust the X-factor in specific instances, it is incumbent on the Commission to ensure that the starting price adjustments are forward looking, and reflective of factors affecting individual suppliers (e.g. any significant capital expenditure).

Ensuring that the DPP is a forward looking regulatory instrument is important for its ongoing credibility.

- *The treatment of capital expenditure*

Whilst related to the need for a forward looking approach, Aurora considers that the treatment of capital expenditure is a separate and important issue in its own right. Where an EDB undertakes significant capital expenditure (such that the regulatory asset base increases after accounting for regulatory depreciation), then other things being equal, an increase in prices is warranted. Aurora contends that it should be fairly easy to account for this in the starting price adjustment process. However, the Commission has tended to see capital expenditure as a 'special circumstance' that warrants affected EDBs moving to a CPP.

The Commission's views in this regard appear to be heavily influenced by a 2007 study undertaken by Farrier Swier Consulting (FSC) in the Commission's preparations for the 2009 reset of the price path threshold under the former (i.e. now repealed) Part 4A of the Act. In this study, FSC did not find evidence to support an imminent 'wall of wire', and mostly found that the ratio of capital expenditure to depreciation for an EDB was less than one. In the *Discussion Paper*, the Commission comments:

> *"... fluctuations in economic factors ... can lead to a supplier's returns in any given year being higher or lower than that which can be expected to be consistent with a longer term measure of returns. For example, suppliers may be facing a step-change increase in asset replacement in the following regulatory period. The Commission, however, considers this is likely to not be the case for EDBs during the current regulatory period – consistent with the findings of the 2007 Farrier Swier study. ..."* [27]

Aurora, however, notes that recent regulatory disclosures suggest that capital expenditure has exceeded depreciation. For instance, in aggregate, EDB Regulatory Investment Values have increased by more than their indexed adjustment. This suggests that capital expenditure is greater than depreciation in aggregate for the industry. It therefore appears that an increasing regulatory asset base (aside from indexation) is common for EDBs. As such, it is not appropriate for the Commission to suggest this is a 'special circumstance' that warrants the time, expense and uncertainty of a CPP.

These specific concerns should be addressed in the process for determining starting price adjustments. As alluded to previously, Aurora is supportive of qualitative assessments informed by Asset Management Plans and low cost partial building blocks type analysis. Aurora recommends that the Commission reject its current proposals in favour of developing and implementing its June 2009 preliminary views.

[27] refer to *Discussion Paper*, para 4.17

5 Other Related Issues

In this section, Aurora addresses several other issues that relate to, or are relevant to, the Commission's proposals for starting price adjustments.

5.1 Elements of the Commission's Proposals Supported by Aurora

Aurora supports the following elements of the Commission's proposals:

- The Commission's intention to use the latest disclosure information rather than information that would have been available when the Commission first determined starting prices for the *2010 Reset*.
- The Commission adjusts disclosed ROI values in order that they are consistent with the manner in which the WACC is calculated—making ROIs more directly comparable with the WACC.
- The Commission intends to make starting point adjustments to the edge of the 'ROI Band' rather than the mid-point. However, Aurora believes that the lower bound of the 'ROI Band' should be no lower than the 50th percentile of the WACC range to ensure that investment incentives are retained.

5.2 Timing Considerations

The Commission intends to make starting price adjustments in the third quarter of 2011, with adjusted prices having effect on 1 April 2012. In an updated Process Paper (dated 3 May 2010 – thereby preceding the *Discussion Paper*) the Commission describes its process for determining starting price adjustments. Aurora notes, that as part of this, the Commission intends to serve EDBs with an information request in January 2011 (requiring EDBs to furnish that information in April 2011). Given the emphasis the *Discussion Paper* places on current and past profitability, Aurora wonders how this information request will be assessed given the Commission's approach in the *Discussion Paper*. However, Aurora notes that the updated Asset Management Plans will be available by April 2011. These will provide the Commission with useful information on expected capital expenditure over the regulatory period should the Commission seek to undertake more qualitative assessments to assess projected profitability.

5.3 Efficiency Gains and Price-Quality Integration

Aurora notes that DPP starting price adjustments are being considered in isolation of price-quality integration. Also, the Commission does not intend that an ECM (or IRIS) should apply in the case of a DPP. Aurora has previously described how an extended 'ROI Band' may allow the incentives of an ECM to be approximated. Aurora also believes that incentives for superior quality should also be taken into account in the DPP. Exactly how this is to be accommodated in the resetting of the DPP remains to be determined.