

POWERCO

**POWERCO SUBMISSION IN RESPONSE TO
STARTING PRICE ADJUSTMENTS FOR DEFAULT
PRICE-QUALITY PATHS DISCUSSION PAPER**

10 SEPTEMBER 2010

CONTENTS

A: INTRODUCTION	3
B: EXECUTIVE SUMMARY	4
C: THE IMPORTANCE OF THE PO ADJUSTMENT METHODOLOGY	5
D: THE COMMISSION'S PROPOSAL	8
E: GENERAL COMMENTS ON THE COMMISSION'S PROPOSAL	9
F: THE ROI BAND	17
G: OTHER ASPECTS OF A PO ADJUSTMENT	20
H: NEXT STEPS	21

A: INTRODUCTION

- 1 Powerco Limited (*Powerco*) welcomes the opportunity to make this submission on the Commerce Commission's discussion paper *Starting Price Adjustments for Default Price-Quality Paths* (5 August 2010) (*Discussion Paper*).
- 2 This submission should be read in conjunction with (and is intended to be complementary to) the Electricity Networks Association's (*ENA*) Submission on Method to Adjust DPP Starting Prices (10 September 2010).
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B: EXECUTIVE SUMMARY

- 4 The methodology for determining starting price adjustments (or “Po adjustments”) is fundamental to establishing a price control regime under Part 4 that gives the necessary certainty firms need before they can make long term investments. All the effort being put into the other Input Methodologies could be undermined if the regulated firms face unpredictable, non-transparent price adjustments every five years.
- 5 Powerco appreciates the Commission’s commitment to consultation in this important area. Some progress has been made in developing the methodology, and the release of the excel spreadsheet that accompanied the Discussion Paper was a good tool that has assisted parties in understanding and engaging with the Commission’s proposals.
- 6 Powerco also acknowledges that the Commission is looking for a Po adjustment methodology that does not involve a full blown building blocks analysis or replicate the CPP process. This means the Commission must strike a balance between the benefits of a less detailed methodology and concerns over the ability to test information¹.
- 7 Recognising these challenges, unfortunately there are a number of concerns that Powerco has with the Starting Price Adjustments Discussion Paper. The most significant of these issues are:
 - 7.1 given the importance of the methodology in establishing a stable investment environment, it should be an input methodology;
 - 7.2 the proposed methodology is insufficiently forward looking, and makes no attempt to inquire into the circumstances facing the firm in the next regulatory period. The concerns over the quality of forecasts have led to the Commission dropping all firm-specific forward-looking analysis of whether an adjustment is needed, and this is not the right balance;
 - 7.3 even on its own terms the proposal is incomplete. While this is acknowledged in the Discussion Paper, the gaps are material and make it difficult to comment on the overall impact of the proposed methodology. As described in this submission, the Discussion Paper understates the issues that need to be worked through in order to establish a credible ROI band and to “normalise” historic ROI performance. We are some distance from a set of rules that will give businesses the confidence that they will keep an appropriate share of any fruits of risk taking; and
 - 7.4 given that there are a number of material gaps in the proposed methodology, the Commission and industry need to make best use of the time left to develop the methodology. A workshop or conference early in 2011 would be a useful addition to the consultation process.
- 8 These concerns are explained in the following sections.

¹ Commerce Commission “*Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*” (5 August 2010), paragraph 3.16.

C: THE IMPORTANCE OF THE PO ADJUSTMENT METHODOLOGY

The role of the Po adjustment

- 9 The Po adjustment methodology is an integral part of any price control regime. The task is to replicate the dynamic in a competitive market where an innovative firm captures the super-returns to any innovation or successful risk taking, but after a period of time competition erodes the competitive advantage and the gains are shared with consumers in the form of lower prices.
 - 10 When this objective is borne in mind, there are some important implications for the Po adjustment methodology:
 - 10.1 the success of the Po methodology can be assessed by the strength of the investment incentives it creates. The objective is to assure businesses like Powerco that if they take risks, invest more capital, try new processes and new technologies, and those risks pay off, then the firm will keep the gains for a period of time that justifies taking the risk;
 - 10.2 past profits are not evidence of any wrong-doing. Consumers have the reassurance of prices being capped by the DPP. Past profits are evidence of successful risk taking and successful performance;
 - 10.3 the objective is not to keep a firm's ROI as close to the industry average as possible. Quite the opposite – the objective is to create incentives for the firm to take risks, invest, and get its ROI above the industry average;
 - 10.4 while the Po adjustment methodology must also share efficiency gains with consumers over time (something Powerco accepts and supports), this should be done at a rate that does not undermine the incentives discussed above. The long term interests of consumers will be best served by ensuring the Po adjustment methodology sends strong, clear signals to the management of regulated suppliers that it is worthwhile to take risks and invest.
 - 11 In summary, from the perspective of an infrastructure business contemplating long term investments, it is important that the Po adjustment methodology:
 - 11.1 shares the efficiency gains with consumers at a rate that leaves the business with enough incentives to take the risks involved in making the investments and creating the efficiencies; and
 - 11.2 is clear, predictable and stable.
 - 12 The importance of the second feature above cannot be under-estimated. If the Po adjustment methodology is not clear, predictable and stable then the Po adjustment process can undermine the entire price control regime. All the long term value of setting other Input Methodologies and establishing a credible, ex ante, low discretion price control regime will be lost if the regular cycle of Po adjustments are unpredictable and discretionary.
- Commercial context**
- 13 Powerco's most recent Asset Management Plan (AMP) provides a commercial context for these issues.

- 14 As discussed in Powerco's AMP, over the past seven years Powerco has doubled expenditure on its network. Significant expenditure has been directed towards renewals and maintenance, reflecting the increasing age of the network and growing proportion of assets reaching the end of their useful lives. However, despite this increase in expenditure, Powerco's reliability has remained static. This is illustrated in figure 1.

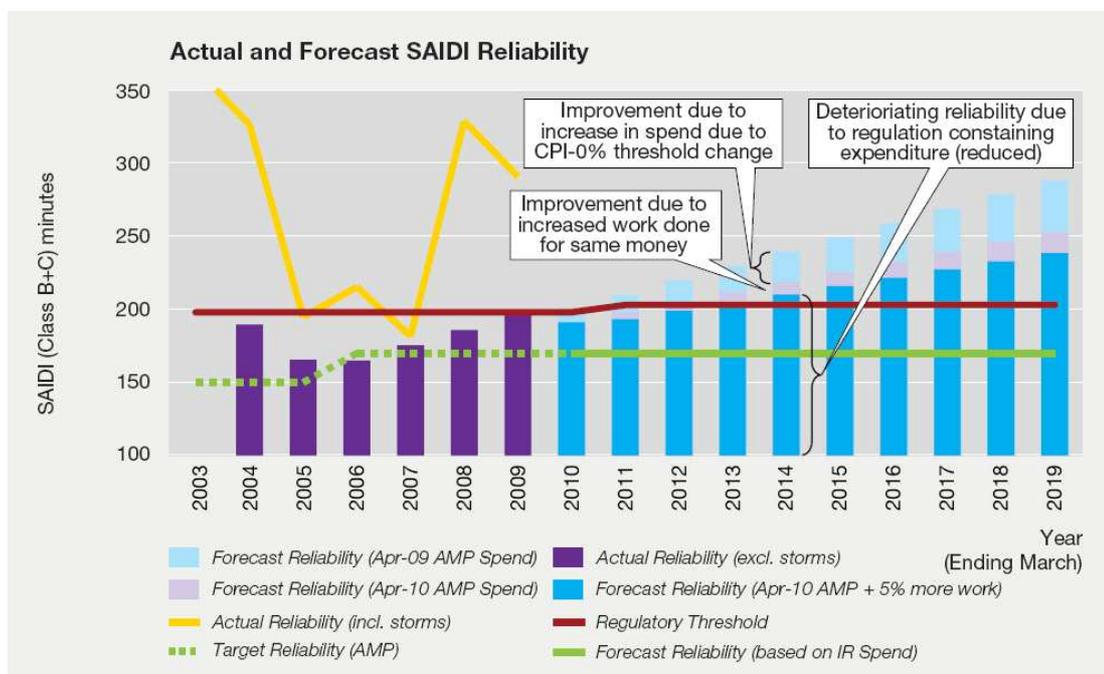


Figure 1: Actual and Forecast Reliability Performance²

- 15 Powerco takes this risk to reliability very seriously and has committed to a further step-up in expenditure to minimise the risks. Powerco's Asset Management Plan 2010 committed an additional annual \$5.5 million capital expenditure, growing to \$6.7 million by 2020. The forecasted impact of this investment in reducing SAIDI is shown in Figure 1.
- 16 Powerco was able to commit to an additional \$5.5 million capital expenditure due to the outcome of the Default Price Path from 1 April 2010. For the past six years Powerco's prices have reduced 2% per annum in real terms (under an X factor of 2) and from 1 April 2010, Powerco is able to maintain its prices in real terms (under an X factor of 0).
- 17 This proposal to increase capital expenditure illustrates some of the points discussed above:
- 17.1 when the regulatory framework does provide ex ante certainty businesses will respond by investing. The Commission needs to be confident the Po adjustment methodology will not undermine the stability created by other aspects of the Part 4 regime;

² More information is provided in Powerco's Asset Management Plan, Information Disclosure for Electricity Networks 2010-2019.

17.2 the assessment of profitability and investment incentives needs to be forward looking. An historical analysis of Powerco's performance conducted in 2010 would miss the significant capital expenditure proposed in the AMP, how that might impact on profitability, and how to maintain incentives for that investment to continue.

D: THE COMMISSION'S PROPOSAL

- 18 The Discussion Paper describes the following framework for making a Po adjustment (at paragraph 3.7):
- 3.7 *The Commission proposes the following steps to undertake starting price adjustments:*
- a. *calculate the supplier's returns using ROI statistics and other information;*
 - b. *assess the supplier's profitability by comparing the supplier's returns against an industry-wide ROI band centred around the WACC point estimate provided by the cost of capital IM (the Draft IMs establish this to be the 75th percentile of the IM vanilla WACC range);*
 - c. *if a supplier's returns are above or below the ROI band, calculate the percentage difference with respect to the relevant limit of the ROI band (**ROI differential**);*
 - d. *translate the ROI differential into an adjustment to supplier's actual weighted average prices or revenues for a specified year, where the supplier's adjusted weighted average prices or revenues become the starting prices for the next regulatory period.*
- 19 The Discussion Paper also sets out the purpose and proposed approach for setting the values of each of the components of the Po adjustment framework, including the calculation of supplier returns, the setting of an ROI band, and the treatment of efficiencies.

E: GENERAL COMMENTS ON THE COMMISSION'S PROPOSAL

The Po adjustment methodology must be an input methodology

20 Powerco continues to submit that the Po adjustment methodology must be an input methodology and refers the Commission to Powerco's and ENA's previous submissions on this issue.³

21 In addition to the arguments made in those submissions, Powerco submits that the importance of the Po adjustment methodology to the overall price control framework reinforces why the methodology should be included as part of the rules and processes input methodology. Most importantly, suppliers require a Po adjustment methodology that is clear, predictable and stable. This can only be achieved where the Po methodology is an input methodology, and which would therefore be subject to the purpose of input methodologies to promote certainty for suppliers and consumers.

22 Currently, it is not clear what status the Commission intends for the Po adjustment methodology. As such, it is difficult to determine what statutory checks exist on the Commission's ability to alter the Po adjustment methodology in the future. This does not engender the certainty that is required to promote investment. On the other hand, the processes for input methodologies are tightly prescribed and subject to clear statutory constraints.

The proposed methodology is incomplete

23 Powerco appreciates that consultation on the Po adjustment methodology has been limited while the Commission has focused on the development of the other Input Methodologies. The Po adjustment methodology outlined in the Starting Price Adjustment Paper is a development of the Commission's preliminary views consulted on in its Reset of Default Price-Quality Path for Electricity Distribution Services Discussion Paper.⁴

24 However, as the Commission acknowledges, there are a number of important aspects of the Po adjustment methodology that have not yet been developed by the Commission for consultation. The Discussion paper states at paragraphs 1.10 and 3.14:

1.10 Consideration of other matters relevant to the starting price adjustment process, and which are not related to IMs, has been deferred and will be addressed as part of future consultation after the IMs are finalised. Those matters include:

- *Information requests: to the extent practicable, the Commission intends using existing information to inform analysis of supplier-specific starting price adjustments, particularly information available through information disclosure regulation. For the initial starting price adjustments for EDBs, GTBs and GDBs, however,*

³ Powerco "Submission 1 in Response to Draft Input Methodology and Information Disclosure Determinations" (9 August 2010), paragraphs 88-89; ENA "Letter to Mark Berry: Starting Price Adjustment Methodology" (23 July 2010).

⁴ Commerce Commission "Reset of Default Price-Quality Path for Electricity Distribution Businesses, Discussion Paper" (19 June 2009) pages 57-80.

the Commission is likely to require suppliers to prepare and provide certain information (e.g., to take account of relevant IM decisions), for example under s 53ZD, given that relevant information is unlikely to be available through information disclosure;

- *Information normalisation: detailed consideration of information normalisation issues relating to setting components of the starting price adjustment framework;*
- *Implementing starting price adjustments: consideration of how an adjustment is given effect (e.g., how starting price adjustments are specified, and the setting of alternative rates of change as an alternative (in whole or in part) to a starting price adjustment); and*
- *Interaction of claw-back provisions: consideration of how the potential application of claw-back provisions under s 54K(3) may fit into the starting price adjustment process for EDBs. There is a similar provision under s 55F(4), however the initial DPP for GTBs and GDBs will not be set until after IMs are published.*

3.14 *There are a variety of issues that need to be considered in translating an ROI differential (i.e., the difference between the supplier's ROI and the upper/lower bound) into an adjustment to the supplier's starting revenue or price.⁵ These issues are not explored in this Discussion Paper, but the Commission is interested in considering submissions on this process before developing its views on this matter any further. These issues include:*

- *the process for consulting with suppliers on the nature of any adjustments;*
- *consideration of whether the adjustment is likely to result in undue financial hardship to the supplier or price shocks to consumers to determine whether an alternative rate of change may be necessary, including:*
 - *how this might be assessed;*
 - *ensuring that any adjustment incorporating a glide path, which effectively would result in an alternative rate of change is equivalent in revenue terms to a one-off starting revenue or price adjustment;*
- *implementation of the starting price adjustments, including:*

⁵ *The Commission considers that it is appropriate for the ROI differential calculations to be expressed in terms of actual revenue (e.g., the illustrative worked example in Section 6 bases analysis on actual line charge revenue and actual distribution line charge revenue for EDBs). Expressing adjustments in terms of a supplier's actual revenues is likely to be the most relevant to both the supplier and consumers. Analysis on an actual revenue basis is also consistent with the information provided under information disclosure regulation.*

- *the specification of the starting price adjustment as part of the price path compliance assessment formula (see paragraph 3.15 below);*
- *relevant considerations for making the initial adjustments (e.g., the implications for specifying adjustments for EDBs during the regulatory period);*
- *industry-specific considerations (e.g., the implications for specifying an adjustment under a weighted average price-cap or total revenue-cap);*
- *the interaction of starting price adjustments with compliance obligations (e.g., the Commission considers that, to the extent a breach of the price-path in the previous regulatory period affects the starting price adjustment process, the supplier should not benefit from this breach);⁶*
- *the interaction of starting price adjustments with relevant claw-back provisions.*

3.15 *The Commission notes that for the purposes of the price-path compliance assessment formula (which has been set for EDBs subject to any changes needed for consistency with IMs, but is yet to be determined for GTBs and GDBs), starting price adjustments expressed as actual revenue adjustments will need to be expressed in terms of an allowable notional revenue at the start of the regulatory period. This will need to be expressed on a different basis to actual revenue. For EDBs, for example, this is because:*

- a. *allowable notional revenue reflects an EDB's allowable revenue, rather than the actual revenue it receives;*
- b. *allowable notional revenue includes a t-2 lagged quantities term;*
- c. *allowable notional revenue is net of pass-through costs (and potentially recoverable costs); and*
- d. *with the exception of the initial starting price adjustment, the ROI calculation would be based on the fourth year of the previous regulatory period and therefore allowable notional revenue would need to be adjusted for the effect of CPI-X over the fifth year.*

25 These areas (in particular those set out in paragraph 1.10) are very significant to regulated suppliers. However, the proposed Po adjustment methodology does not yet meet the standard identified above – it is not yet clear and predictable in a way that will give Powerco and other EDBs and GPBs confidence that they can make

⁶ For example, this may be an issue when both actual and allowable revenues fall within the ROI band and when specifying a zero starting price adjustment (i.e., specifying in terms of the prices that the supplier was allowed or actually charged). The Commission notes that issues of breach will be considered separately from the starting price adjustment process.

long term investments knowing how this crucial decision will be made every 5 years.

- 26 While the Commission intends to consult on these issues at a later date, the absence of any developed thinking on these areas makes it difficult to comment on the Discussion Paper. For example, it is difficult to comment on the efficacy of the ROI band concept, and its proposed width, without knowing how the Commission proposes to “normalise” information on historic performance. A range of statistical techniques could be applied to conduct such a normalisation, each of which may deliver materially different results. Given the absence of detail on the intended normalisation, further detailed consultation on this matter is essential.
- 27 More generally, the impact of the Po adjustment methodology on investment incentives will be assessed as a whole. All of the issues identified in paragraph 1.10 – the information the Commission will use, how it will be normalised, how any starting price adjustments will be imposed and questions of claw back – have the potential to impact on the way management of firms view the risk/reward trade-offs of future investment.
- 28 As the proposal currently stands no regulated supplier will be able to answer the three questions which are being asked of them by their capital suppliers:
- 28.1 What year will be used in assessing the profitability on which any Po adjustment will be based? The Discussion Paper used 2008/09 data as its starting point, but noted that normally the fourth year of the previous regulatory period would be used.⁷ But why use an old measure of profitability when a more recent year is available (2010) and the legislation refers to current and future profitability?
- 28.2 What will be the process for dealing with any section 54K(3) claw backs and how will any Po adjustment, if required, be implemented? Will this process take account of future capital requirements? Will there be a one off adjustment or will it be spread over several years?
- 28.3 How will the process of normalisation be undertaken? The Commission does not want to look forward but proposes to use historic data to undertake an unexplained process of normalisation. How predictable will this process be?

The proposed methodology is not sufficiently forward looking

- 29 As the Discussion Paper recognises, section 53P(3) requires the Commission to set starting prices as either the prices that applied at the end of the preceding regulatory period or “*prices, determined by the Commission, that are based on the **current and future profitability** of each supplier*” (emphasis added). This emphasis on a forward-looking assessment is supported by section 53P(4) which makes it clear that any claw back must not relate to profits from a previous regulatory period. This is consistent with the role of the Po adjustment, discussed above.

⁷ Commerce Commission “*Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*” (5 August 2010), paragraph 3.15(d).

30 From these starting points, it has been surprising that the major change proposed by the Discussion Paper is an explicit decision to drop from the Commission's proposed methodology, a qualitative forward looking assessment.

31 Powerco appreciates that the Commission does not resist the idea that Po adjustments should only be made in response to assessments of future profits, and should not attempt to claw back past profits. However, the Discussion Paper argues that the remaining aspects of the Commission's proposed Po adjustment methodology will nevertheless address the need to look forward (and to be confident there is no looking backward):

3.17 However, the Commission recognises the need for any starting price adjustments to be based on both current and projected profitability. To the extent that the Commission's assessment of a supplier's current returns are not necessarily a good guide for the supplier's actual returns over the next regulatory period, projected profitability is taken into account through:

- **the WACC:** *the WACC is forward looking and projected profitability is implied for the regulatory period (see paragraphs 4.8-4.14 for further discussion);*
- **the ROI band:** *the ROI band is intended to implicitly take account of historical and future uncertainties in the profitability assessment that have a bearing on both current and projected profitability (see paragraphs 4.15-4.20 for further discussion); and*
- **scope to increase efficiency:** *assuming that suppliers are not fully efficient already, a DPP provides scope for the supplier to increase their profitability going forward through expenditure reductions over and above those already implicit in the CPI-X price path.⁸*

3.18 The Commission recognises that there may be circumstances where future expenditure requirements differ significantly from those implied by the starting price. Therefore the starting price adjustment process might not appropriately reflect those particular circumstances of a supplier that affect its projected profitability. In such instances, there are likely to be alternatives available to the supplier for better meeting these particular circumstances as contemplated by s 53K, such as the option of making a CPP proposal.

32 In essence, the argument seems to be:

32.1 that past ROI performance of the business, perhaps normalised in a way yet to be developed, is an adequate forecast of "current and future profitability";

32.2 to the extent that past performances is an imperfect predictor of future profitability, the ROI band will account for acceptable variations in both

⁸ Relative cost efficiency is not assessed as part of starting price adjustments as the Commission is precluded from doing so under the Act.

measuring past ROI, normalising the information, and variations in its predictive power; and

32.3 to the extent this framework results in a Po adjustment that is not sensitive to future operating conditions and leaves a firm exposed in the forthcoming regulatory control period the firm can make a CPP application.

33 Powerco has several concerns with this approach. First, the framework seems directed toward ensuring a firm's ROI does not stray too far from the industry average, rather than assuring firm management that it is worthwhile taking risks in pursuit of the above normal returns. The Commission is sending a signal that firms should aim to beat the industry average by a little bit. We think the industry should aim higher.

34 Second, there are some relatively simple, reliable inquiries that could be made into the circumstances facing the firm over the next regulatory period. A key factor is future capital and operational expenditure laid out in a firm's AMP. The Commission has the ability to conduct a high level check on the trend in future average costs (and thus profitability) before deciding whether to make a Po adjustment, and it should do so.

35 Third, it is not an answer to say the firm can apply for a CPP if the adjustments based on historical performance do not work for the next regulatory period. The CPP process is likely to be costly and lengthy. More fundamentally, if a firm has been put in a position where a CPP is necessary, then it will only be because the proposed DPP Po adjustment does not reflect current and future profitability. In other words, that the proposed adjustment does not meet the statutory test. In those circumstances it is not an adequate answer to say the firm can submit itself to the cost and delay of a CPP process.

36 Fourth, the proposed ROI band is unlikely to adequately recognise variations in measuring the ROI at a point in time, let alone the level of uncertainty associated with the ROI that is realised over the future regulatory period. It will also not recognise the uncertainties associated with the normalisations proposed by the Commission, and the difficulties with using past performance to estimate future performance.

37 Fifth, the ROI band is itself subject to measurement error. The ROI band is centered around a point estimate of WACC. The Commission proposes to use the 75th percentile estimate of WACC, which means there is a 25% chance of the ROI band being inaccurate for the role proposed by the Commission, before issues with the ROI data are considered.

38 Powerco submits there are two alternative changes that could be made to the proposed methodology to respond to these concerns.

39 The first, and most preferable, is to reinstate the second qualitative step in the Commission's methodology. It is very hard to envisage a robust, stable methodology without an assessment of the circumstances of the firm – prior to any decision as to whether to require a price adjustment. This assessment could focus on specific, significant cost and profitability drivers based on a firm's AMP.

40 The second alternative is to consciously set the ROI band conservatively wide, to minimise the downside of the “historical performance as predictor of the future” approach. This is not Powerco’s preferred solution, but if the Commission continues with this framework then Powerco submits it is necessary. The width of the ROI band is discussed in the next section.

Treatment of inflation

41 Powerco also has substantial concerns with how the Commission proposes to deal with inflation when measuring the ROI and comparing it to the WACC in the base year. The Commission has proposed treating all of the inflation indexation component as a revaluation gain (and therefore as part of income) when calculating ROI and to compare this with the nominal WACC that has been calculated in line with the Input Methodology. The effect of this approach is that an unusually high level of inflation in the base year will flow through directly into a higher measured ROI – and hence a higher chance that a Po reduction is required.

42 The Commission’s proposed method therefore creates a number of highly undesirable outcomes.

43 First, the outcomes of the Po review may differ materially depending upon the base year that is chosen. If the Po review uses a base year that had experienced unusually high inflation, then there would be a greater chance that a Po reduction would be required than if the review was conducted when inflation was lower than expected. Such a ‘roulette wheel’ effect cannot be discounted given that it is not uncommon for a year of unusually high inflation to be followed by one of low inflation (that is, if transitory price increases are reversed).

44 Secondly, the Commission’s method means that regulated businesses will only be permitted to earn the same nominal return irrespective of the level of actual inflation – and hence be required to earn lower real returns if inflation is higher than expected, and vice versa if inflation is unexpectedly low. This outcome is contrary to the intention of CPI-X regulation, which has as a core proposition that investors should be protected from inflation risk (that is, receive the same real return irrespective of the level of inflation).

45 The most straightforward means of ensuring the correct treatment of inflation risk – and thus preserve the central tenet of CPI-X regulation – would be to express the WACC in real terms (that is, to deduct an unbiased forecast of inflation for the period that corresponds to the term of the risk free rate instrument, using the Fisher transformation) and then to ignore revaluation gains when calculating ROI. This has the effect of permitting businesses to earn the real WACC plus actual inflation, as intended by a CPI-X regime. However, other equivalent methods of achieving this objective could be derived, including to:

45.1 calculate the revaluation gain using the forecast of inflation that is built into the WACC (that is, an unbiased forecast of inflation for the period that corresponds to the term of the risk free rate instrument) rather than the actual value; or

45.2 calculate a nominal WACC that reflects the actual level of inflation for the base year rather than the rate that is built into the risk free rate instrument.

Treatment of efficiencies

- 46 The basic premise of the Commission's proposed treatment of efficiencies appears to be that a supplier will be entitled to retain efficiency gains until the next DPP reset, at which point if the supplier's returns are greater than the ROI band upper limit a downward starting price adjustment will be undertaken. The realignment of a supplier's returns to the ROI band would therefore serve as a proxy for sharing efficiency gains with consumers.
- 47 Though simple, the Commission's views on the treatment of efficiency gains under the Po adjustment methodology raise more questions than they provide answers:
- 47.1 if the ROI band is to serve as a proxy for the sharing of efficiency gains, will the band be calibrated to account for this?
- 47.2 how will the Commission's treatment of efficiency gains accommodate step changes in efficiency if the limit on retaining efficiency gains is effectively 5 years?
- 47.3 how will the Commission's proposal avoid incentivising suppliers to make efficiency gains only at the start of a regulatory period?
- 47.4 will efficiency losses be treated similarly? That is, borne by the supplier for a maximum of 5 years until the Commission implements an upwards starting price adjustment at the next DPP reset.
- 47.5 will remaining efficiency gains from a previous regulatory period be included in the assessment of projected profitability for the next regulatory period?
- 48 But the most fundamental question is this – will the efficiencies framework incentivise suppliers to make step change efficiency gains? The Discussion Paper does not give Powerco comfort that this will be the case. Certainly, a 5 year limit on retaining efficiency gains is not the way to go about creating such conditions.
- 49 Powerco submits the treatment of efficiency gains under the DPP is a matter that requires further attention. Powerco shares the view of ENA⁹ that discussion of the treatment of efficiencies is somewhat premature in that the Commission has yet to determine the input methodologies, including the final form of the Incremental Rolling Incentive Scheme (*IRIS*) and whether the *IRIS* will apply to the DPP.

Other issues

- 50 One set of issues that is likely to be less complex to resolve than the Commission's discussion suggests are those summarised in paragraph 3.15 of the consultation paper. Turning to the first of these, the simplest means of translating an intended change to actual revenue into notional revenue is to assume that the structure of prices remains constant – this ensures that the percentage change to actual and notional revenue will be identical irrespective of the weights that are applied. Powerco understands that this simplifying assumption is commonly adopted by Australian regulators when deriving new price controls from the building block outcomes.

⁹ ENA "Submission on Method to Adjust DPP Starting Prices" (10 September), paragraph 42.

F: THE ROI BAND

The WACC point estimate

- 51 Powerco disagrees with the Commission's proposal to use the 75th percentile of the WACC range for the purpose of undertaking starting price adjustments and submits that the Commission should apply the 90th percentile, reflecting the appropriate point estimate for the cost of capital input methodology.
- 52 Powerco refers the Commission to its 13 August 2010 submission on cost of capital in which we submit that the requirement on the Commission to provide incentives for investment in the context of real and material risk associated with the estimation of the WACC should lead the Commission to apply a WACC at the 90th percentile of the range that is established.¹⁰

The width of the ROI band

The Commission's proposal

- 53 The Commission proposes to "use an ROI band to allow for uncertainty in a point estimate of a supplier's returns".¹¹ This ROI band is intended to allow for the uncertainty in (i) using past ROI to estimate future ROI created by use of accounting information in the historic ROI calculations and (ii) economic factors that cause ROI to fluctuate over time.¹²
- 54 The Discussion Paper is clear that the ROI band is not intended to recognise the uncertainty associated with estimating WACC. Rather, this is said to be adequately recognised by using the 75th percentile estimate of WACC.¹³

Comments on the Commission's proposal

- 55 The starting point is that the Commission's proposal involves comparing two parameters that can only be estimated – the industry WACC and the firm's ROI. Both estimates will have associated estimation error. Further, the Commission proposes to use the historic estimate of ROI as a predictor of future ROI, introducing a third source of estimation error.
- 56 The Commission further asserts in its worked example that most of the variations on other components will not be reflective of future volatility, and that changes in the volatility of revenue can be ignored because revenue in the past has been correlated with operating expenditure. The Commission has also emphasised the difficulty with estimating the volatility in measured ROI in light of changes to accounting and regulatory practices in the past.
- 57 Powerco notes that the fact that asset valuation practices and other accounting principles may have changed over the past does not mean that a reliable and informative confidence interval for the ROI for a particular year cannot be derived.

¹⁰ Powerco "Submission 2 in Response to Draft Input Methodology Decisions and Determination: Cost of Capital" (13 August 2010), paragraphs 16-26.

¹¹ Commerce Commission "Starting Price Adjustments for Default Price-Quality Paths Discussion Paper" (5 August 2010), paragraph 4.15.

¹² Commerce Commission "Starting Price Adjustments for Default Price-Quality Paths Discussion Paper" (5 August 2010), paragraph 4.12.

¹³ Commerce Commission "Starting Price Adjustments for Default Price-Quality Paths Discussion Paper" (5 August 2010), paragraph 4.16.

Rather, the appropriate target is to ascertain the uncertainty in the measured ROI for the year in question given the accounting practices and other matters that applied to that year. This would naturally require an examination of the volatility in the tangible inputs into this calculation, most notably:

57.1 the volatility in operating expenses;

57.2 the volatility in capital expenditure;

57.3 the volatility in revenue that is caused by volatility in demand; and

57.4 the volatility in customer contributions.

58 Of course, a substantial further element of volatility in the measured ROI is introduced by the Commission's method of dealing with inflation when comparing the measured ROI and WACC. The discussion in this section assumes that this fundamental problem with the Commission's proposed method has been remedied, as discussed above.

59 Powerco notes that the Commission's illustrative worked example proposed examining only the volatility in operating expenditure, and to explicitly ignore revenue volatility (on the basis that it is correlated with operating expenditure). Powerco does not agree with the Commission's suggestion that revenue volatility should be ignored – while price-related volatility may not be relevant for this exercise, it is feasible to separate out price and quantity-related revenue volatility, the latter of which is highly relevant and material. Powerco notes that, for its gas business in particular, gas volume (and revenue) is highly correlated to temperature – the lower the temperature the higher the usage. This can be seen in the graph below that correlated monthly volume to degree days (the number of days in a month on which temperature is below 15.5 degrees). A year with an increased number of degree days has a significant effect on Powerco's annual gas volume - in the three year period to 2009 Powerco had an annual 2.5% variation in degree days.

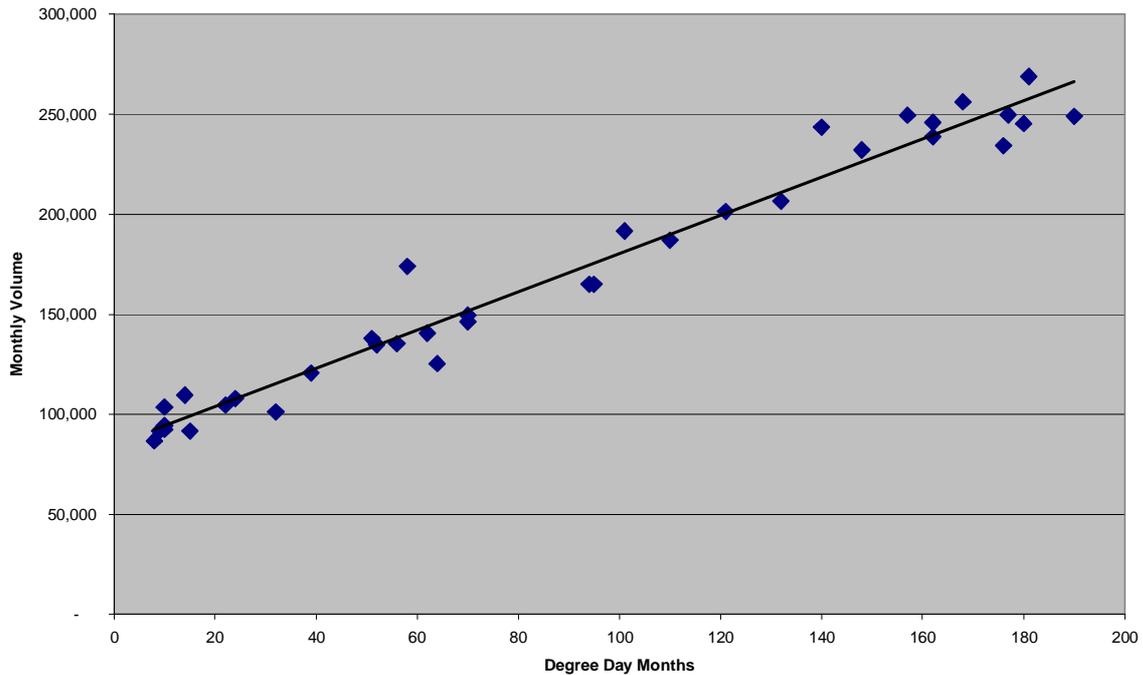


Figure 1 - Powerco monthly gas volume and degree days

- 60 In addition, the Commission’s illustrative work example – even if expanded to address all of the drivers of ROI volatility as discussed above – would only estimate the volatility in measured ROI for the base year. This method would not account for the potential volatility in ROI over the course of the regulatory period and hence not achieve the Commission’s objective of properly allowing for future uncertainty.
- 61 In order to take account of the uncertainty in ROI over the future regulatory period, an analysis also would be required of the accumulated effect of the uncertainty in each parameter on measured ROI over the course of the regulatory period. An important purpose of this analysis would be to take account of the real uncertainty in the level of capital expenditure over one regulatory period compared to another on the RAB – and hence the ROI – over a given regulatory period.
- 62 In the case of the WACC, the use of a 75th percentile WACC estimate (the calculation of which is difficult, relies on heroic assumptions and ignores model error) means that there is a 25% probability that the calculated WACC will not reflect the actual cost of capital of the industry.

G: OTHER ASPECTS OF A PO ADJUSTMENT

Depreciation

- 63 Powerco understands the inherent tension that the Commission faces in designing a DPP framework that is comparatively low cost and generic to apply to the majority of EDBs subject to price control. However, if DPP regulation is to be a viable regulatory mechanism (relative to the CPP) there must be room for some flexibility in its application to individual suppliers.
- 64 As Powerco has consistently submitted, the DPP should allow the application of flexible depreciation.¹⁴ The rate of depreciation is a material factor in the assessment of current and projected profitability, and starting price adjustments should take into account any reasonable variants to the standard straight line depreciation profile where it enables a more accurate assessment of a supplier's profitability.

¹⁴ Powerco *Submission 3 in Response to Draft Input Methodology Decisions and Determinations: Asset Valuation* (20 August 2010), paragraphs 132-134.

H: NEXT STEPS

- 65 The Commission proposes the following process to determine the Po adjustment methodology and implement the first Po adjustment:
- 65.1 determine other input methodologies by 31 December 2010;
 - 65.2 consult on and issue any requests for information to be used for starting price adjustments before 31 March 2011 (essentially an out-of-cycle information disclosure based on the new Input Methodologies);
 - 65.3 publish Draft Starting Price Adjustment Decisions Paper and Draft Amended Determination in Q2/Q3 2011;
 - 65.4 publish Starting Price Adjustment Decisions Paper and Amended Determination in Q3 2011; and
 - 65.5 apply the Po adjustment methodology and implement Po adjustments in Q3 2011.
- 66 As the Commission acknowledges, there remains much work to be done to develop the Po adjustment methodology prior to the first Po adjustment. However, there is time to achieve this.
- 67 The Commission's focus for the remainder of this year lies in developing the input methodologies for determination by 31 December 2010. This leaves the Commission with approximately 9 months in 2011 to consult on and develop the Po adjustment methodology.
- 68 The Commissions' timetable to progress the Po adjustment methodology does not schedule any further consultation until the Commission releases its Draft Starting Price Adjustment Decisions Paper and Draft Amended Determination in Q2/Q3 2011. This is a missed opportunity. At the current time, with the Po adjustment methodology in basic form and missing detail on several key components, Powerco is unable to estimate with any level of accuracy how the DPP will impact on its business. The third quarter of 2011 is too long to wait until things become clearer.
- 69 Powerco suggests that the process to develop the Po adjustment methodology would benefit from a further round of consultation earlier in 2011. There are a number of key issues that Powerco doubts can be dealt with effectively in an exchange of discussion papers and submissions, and we think a workshop or conference would assist industry and the Commission in developing the methodology.