



AUCKLAND ENERGY CONSUMER TRUST

**SUBMISSION TO THE
COMMERCE COMMISSION**

ON ITS

ISSUES PAPER

FOR THE INITIAL DPP FOR GAS PIPELINE BUSINESSES

14 May 2010

AECT'S RESPONSE TO THE COMMERCE COMMISSION'S ISSUES PAPER ON SETTING THE INITIAL PRICE PATH FOR GAS PIPELINE BUSINESSES

Executive Summary

➤ *Introduction*

On 12 April 2010, the Commerce Commission published an *Issues Paper* setting out its preliminary views on how the Initial Default Price-quality Path (DPP) for Gas Pipeline Businesses (GPBs) should be determined.

For GPBs, the legislation requires an initial DPP to be set from 1 July 2010 (or as soon as practicable thereafter). The Commission's initial view is that 1 July 2012 is the appropriate date to commence the DPP for GPBs.

The Commission is seeking submissions from parties in response to the *Issues Paper*. In particular, the Commission has requested submissions in two parts – as follows:

- first, submissions on the form of control; and second,
- submissions on all other sections of the *Issues Paper*.

The Auckland Energy Consumer Trust welcomes the opportunity to participate in this process. AECT appreciates that the Commission has not reached any decisions on setting the initial DPP for GPBs. On 30 April 2010, the AECT made its submission on the *Issues Paper* proposals for the form of control. This submission provides the AECT's comments on other matters arising from the *Issues Paper*.

AECT makes this submission to assist the Commission understand, from the perspective of the Trust (and more generally, from the perspective of a pure investor), the issues/concerns that arise from the Commission's proposals in the *Issues Paper* to set the initial DPP for GPBs.

➤ *Key Issues and Recommendations*

For the AECT, the key issues arising from the Commission's *Issues Paper*, together with the AECT's recommendations for the Commission to consider are:

- 1) **Structure of the Initial DPP** – the Commission proposes that the initial DPP would consist of a price path and quality standards that are separately specified and assessed. The Commission suggests that the potential lack of available and quality data may undermine moves to integrate price and quality under a single price path assessment.

AECT considers that it is in the interests of consumers, GPBs and

investors for price and quality to be integrated within an incentives framework. Price and quality characteristics are set in an integrated manner in most workably competitive markets. This approach is also consistent with the statutory framework.

AECT considers that the Commission has ample time to consider options for integrating price and quality. It is AECT's preference that the DPP provides an S-factor 'quality' incentive in the price path (i.e. the price path is of the form $CPI - X + S$).

AECT recommends that the Commission undertake a process to identify an S-factor type incentive to integrate price and quality within the DPP.

2) Pre-DPP Pricing Arrangements – under transitional arrangements, if a GPB increases its prices by more than the rate of inflation from 2008 to the commencement of the initial DPP, the Commission may claw-back any over-recovered revenues.

AECT believes the transitional arrangement should be interpreted in light of:

- ensuring overall outcomes are consistent with competitive sector outcomes; and
- retaining incentives for investment.

Any assessment of 'over-recovered revenues' must have regard to contemporaneous asset valuations and the cost of capital appropriate for the current conditions in global financial markets, and should avoid 'technical breaches' – otherwise the threat of claw-back, if prices are increased, may deter investment in the long period leading up to the commencement of the initial DPP. This impediment to dynamic efficiency is detrimental to both investors and consumers.

AECT also suggests that any decision on whether to effect the claw-back as part of any adjustments to starting prices, or via price adjustments over the course of the regulatory period, should have full regard to the desirability of avoiding both positive and negative price shocks.

AECT recommends that claw-backs not apply in the case of technical breaches or where price increases can be justified in terms of incremental investment or providing an adequate return in prevailing conditions on contemporaneous investment values.

3) Productivity – the Commission is proposing to adopt a Total Factor

Productivity (TFP) approach to identify the long run rate of productivity improvement for suppliers of gas pipeline services. This is then to be used by the Commission, in a non-mechanistic manner, to set the X-factor for the price path under the initial DPP.

Uncertainty in the determination of TFP is a concern to the AECT. The AECT has a preference for the more traditional TFP approach – as previously used by the Commission in setting the B-factor under the former Thresholds Regime. However, in the 2010 reset of the DPP for electricity distribution businesses (EDBs), the Commission proposed an amended TFP approach (that takes into account sunk costs and financial capital maintenance) which the AECT did not support.

In retrospect, the Commission in fact had regard to both approaches when setting the X-factor for EDBs. The AECT appreciated this non-mechanistic / pragmatic approach, and supported the resulting X=0 outcome.

AECT encourages the Commission to adopt a similarly pragmatic approach in the case of the initial DPP for GPBs – including greater regard to the more traditional B-factor approach.

Given the fairly long timeframe for the setting of the initial DPP, the AECT suggests that the Commission should attempt to identify robust GPB productivity trends from New Zealand gas sector data. Some reference to NZ productivity trends in the electricity lines sector, and/or overseas productivity trends may be required to corroborate and improve New Zealand gas sector trends.

AECT recommends that the Commission continue to use the previous ‘B-factor’ approach for identifying the long run rate of productivity improvement.

4) Other Issues – the AECT also considers other issues such as the setting of quality standards, and timing considerations.

AECT notes that the Commission’s proposals on the timing of regulatory periods will result in Vector’s compliance reporting being non-aligned with its pricing years, and will increase compliance costs for Vector. As Vector’s major shareholder, the AECT finds this proposal by the Commission to be unacceptable. Instead, the AECT fully endorses Vector’s proposal for an alternative regulatory period.

1 Introduction

- The requirement for a Default Price-quality Path (DPP) for both Electricity Distribution Businesses (EDBs), and Gas Pipeline Businesses (GPBs) was introduced by the Commerce Amendment Act 2008.
 - For EDBs, the legislation required an initial DPP to be set as at 1 April 2009, with a full reset from 1 April 2010. In late 2009, the Commerce Commission (Commission) issued its determination for the 1 April 2010 reset of the DPP – with the proviso that the determination will be amended to address ‘Input Methodology’ issues such as P_0 adjustments.
 - For GPBs, the legislation requires an initial DPP to be set from 1 July 2010 (or as soon as practicable thereafter). The Commission’s initial view is that 1 July 2012 is the appropriate date to commence the DPP for GPBs.
- On 12 April 2010, the Commission published an *Issues Paper*¹ setting out its preliminary views on how the initial DPP for GPBs is to be determined.
- The Commission is seeking submissions from parties in response to the *Issues Paper*. In particular, the Commission has requested submissions in two parts – as follows:
 - first, submissions on the form of control; and second,
 - submissions on all other sections of the *Issues Paper*.
- The Auckland Energy Consumer Trust (AECT), as an owner of electricity and gas distribution assets, and gas transmission assets, is affected by the Commission’s proposals and welcomes the opportunity to participate in this process. AECT appreciates that the Commission has not reached any decisions on setting the initial DPP for GPBs.
- On 30 April 2010, the AECT made its submission on the *Issues Paper* proposals for the form of control². This submission, as requested by the Commission, provides the AECT’s comments on other matters arising from the *Issues Paper*. It addresses the following matters from the *Issues Paper*:
 - Structure of the Initial DPP (*Section 2*)
 - Pre-DPP Pricing Arrangements (*Section 3*)
 - Productivity (*Section 4*)
 - Other Issues (*Section 5*)

¹ Commerce Commission; “Initial Default Price-Quality Path for Gas Pipeline Businesses – Issues Paper”; 12 April 2010

² AECT; “Submission to the Commerce Commission on its Issues Paper (on the form of control) for the Initial DPP for Gas Pipeline Businesses”; 30 April 2010

- AECT makes this submission to assist the Commission understand, from the perspective of the Trust (and more generally, from the perspective of a pure investor), the issues/concerns that arise from the Commission's proposals in the *Issues Paper* to set the initial DPP for GPBs.
- AECT requests that the Commission take account of the AECT's concerns and recommendations on the setting of the initial DPP. Without addressing the above concerns, there is a danger the new regulatory regime will not be effectively implemented (i.e. to ensure the intent of the Commerce Amendment Act 2008 is served).

2 Structure of the Initial DPP

- The Commission proposes that the initial DPP would consist of a price path and quality standards that are separately specified and assessed.
- The Commission suggests that data issues – including the lack of availability and quality of data – would likely undermine moves to integrate price and quality under a single price path assessment.
- AECT notes that the Commission has adopted a separate price path and quality standards for the DPP currently in place for electricity distribution businesses (EDBs). However, in setting this DPP, the Commission was working to a very tight timeframe. Time constraints were identified as being a key factor in the Commission decision to treat price and quality separately – rather than in an integrated manner. For instance, the Commission states:

“A DPP is required to specify the maximum prices or maximum revenues of a supplier and the quality standards to be met. The Act does not prescribe how a DPP should be structured to incorporate these. The Reset DPP has been structured to specify and assess the price path and quality standards separately. A breach of either of the price path or quality standards will be considered a breach of the Reset DPP.

The Commission considered whether an integrated price-quality path was appropriate under the Reset DPP. While expressing a general preference for the integrated path, submissions recognised that the period prior to the Initial Reset Determination publication date did not provide sufficient time to develop and implement such a mechanism. Submissions acknowledged this timing constraint and expressed support for the separate assessment of price and quality, at least initially, under the Reset DPP.

Having considered submissions received during the consultation process, the Commission has retained its view that the Reset DPP should take account of both price and quality, and that these should be specified and assessed separately. Price and quality are of primary interest to consumers and therefore critical to their long term interests. Accounting for both price and quality is likely to promote the Part 4 Purpose and provide incentives for Non-exempt EDBs to improve efficiency and provide services at a quality that reflects consumer demands ...”³

- Whilst the AECT accepts the lack of robust data to be a significant issue, it notes that data issues will exist irrespective of whether price and quality are

³ Commerce Commission; “Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses: Decisions Paper”; 30 November 2009; pp 18-19 (paras 3.10-3.12)

assessed separately or in an integrated manner. With the Commission proposing that the appropriate date to commence the initial DPP for GPBs is 1 July 2012, the AECT notes that the Commission is not subject to the same intense time pressure as it was in resetting the DPP for EDBs. This should provide the Commission the opportunity to advance the development of quality incentives that would apply in an integrated price/quality path for the initial DPP.

- AECT considers that it is in the interests of consumers, GPBs and investors for price and quality to be integrated within an incentives framework. Price and quality characteristics are set in an integrated manner in most workably competitive markets. This approach is also consistent with the statutory framework.
- It is therefore appropriate that the Commission consider an S-factor (or similar quality incentive) in the DPP price path to integrate price and quality (i.e. the price path is of the form $CPI - X + S$). In this regard, the AECT notes that the Commission has identified the integration of price and quality as a possible future refinement for the DPP for EDBs. For instance:

“The Commission considered the potential for an integrated price-quality path under the Reset DPP (e.g., using an S-factor mechanism). In general, submissions expressed a preference for such an approach but recognised that time constraints for the Reset DPP meant that development of a potential S-factor mechanism was not feasible. Consistent with this, the Reset DPP is comprised of a separately assessed price path and quality standards. However, the Commission commented that it would further consider the potential to develop such a mechanism. ... It is intended that the “General Issues Discussion Paper” scheduled for publication in June/July 2010 will address the ... topics discussed ... above.”⁴

AECT notes that work on an S-factor has now been deferred until 2011:

“The Commission has deferred further consultation on energy efficiency and quality incentives until 2011. The Commission originally intended to consider these matters as part of its June/July 2010 General Issues Discussion Paper, but now considers that these matters may be better addressed in 2011 when a number of aspects of the DPP have been progressed. In particular these are the specification of price, the

⁴ Commerce Commission; “Further Work on the Reset Default Price-quality Path for Electricity Distribution Businesses: Process paper”; Feb 2010; pp 3, 5 (paras 9 &17)

*compliance assessment formula, IM consistency, and the starting price adjustment methodology.”*⁵

- AECT suggests that it is appropriate for the Commission to simultaneously advance the development of an S-factor type incentive for both the electricity and gas DPPs.

AECT Recommendation:

- **That the Commission undertake a process to identify an S-factor type incentive to integrate price and quality within the DPP.**

⁵ Commerce Commission; “Further Work on the Reset Default Price-quality Path for Electricity Distribution Businesses: Updated Process paper”; 3 May 2010; p 4 (para 15)

3 Pre- DPP Pricing Arrangements

- The Commerce Amendment Act 2008 introduced transitional arrangements as part of the (new) regulatory control provisions of Part 4. These enable the Commission to claw-back certain price increases made by GPBs prior to an initial DPP being established.
- If a GPB increases its prices by more than the rate of inflation – from 1 January 2008 to the commencement of the initial DPP – the Commission may claw-back any over-recovered revenues. In the *Issues Paper*, the Commission does not define the circumstances in which it may be appropriate to apply a claw-back. However, the Commission’s initial view is that any claw-back should be given effect in the determination of any P_0 adjustments to apply at the commencement of the initial DPP.
- AECT agrees with the Commission that claw-back should not apply to the Vector and Powerco pipeline services already subject to regulatory control.
- More generally, however, the AECT considers that the issue of price increases and claw-backs must be seen in the context of the overall Part 4 purpose statement – which includes promoting outcomes consistent with competitive sector outcomes, and incentivising investment. For instance, the Commission does not define what constitutes “*any over-recovery of revenues*”⁶. Two possible interpretations are:
 - i. revenue associated with any price increase in excess of CPI; or
 - ii. revenue giving rise to an excessive return over the period in question.
- The second of these interpretations is more consistent with the overall Part 4 purpose statement, as it recognises that price increases in excess of CPI may be justified (e.g. due to ongoing investment in the pipeline network). However, the threat of claw-back – if prices are increased – may deter investment in the long lead-up to the initial DPP.
- This impediment to dynamic efficiency is detrimental to both investors and consumers. In the AECT’s view, until Input Methodologies are determined, it would not be unreasonable for any assessment of ‘over-recovered revenues’ to have regard to contemporaneous asset valuations, and to the current conditions in global financial markets. This would reduce the regulatory uncertainty that investors currently face. It would, however, be unreasonable for the Commission to seek claw-back from 2008 to 2012 on the basis of Input Methodologies that are only introduced toward the end of that period.

⁶ Refer to section 55F(2) of the Commerce Act 1986

- In addition, the Commission’s proposal to have four assessment periods increases the likelihood of a technical breach occurring. For example, if a supplier were to:
 - increase prices by more than CPI in one period (perhaps as a result of a forecasting error); but then
 - compensate for this by a price increase less than CPI in a subsequent period,

it would not be consistent with the Part 4 purpose statement to apply claw-back in these circumstances.

- AECT understands that Vector is actively seeking to comply with the transitional arrangement requirements and not increase prices by more than CPI. On this basis, the Commission’s proposals should have little consequence for AECT and Vector. However, for the reasons identified above, both AECT and Vector are affected by regulatory uncertainty, and the Commission’s proposals do little to reduce this.
- AECT does not accept that a claw-back is needed or is in the interests of achieving competitive market outcomes. This is in the context of: the AECT being unaware of any unjustified price increases; and, the need for regulatory and investor certainty at this point in time (especially as the Commission, in consultation with the industry and other interested parties, is still in the process of determining what, and how, asset valuation and cost of capital are to be applied in determining whether revenue has been over-recovered).
- The AECT also suggests that any decision on whether to effect the claw-back as part of any adjustments to starting prices, or via price adjustments over the course of the regulatory period, should have full regard to the desirability of avoiding both positive and negative price shocks.

AECT Recommendation:

- **That claw-backs not apply in the case of technical breaches or where price increases can be justified in terms of incremental investment or providing an adequate return in prevailing conditions on contemporaneous investment values.**

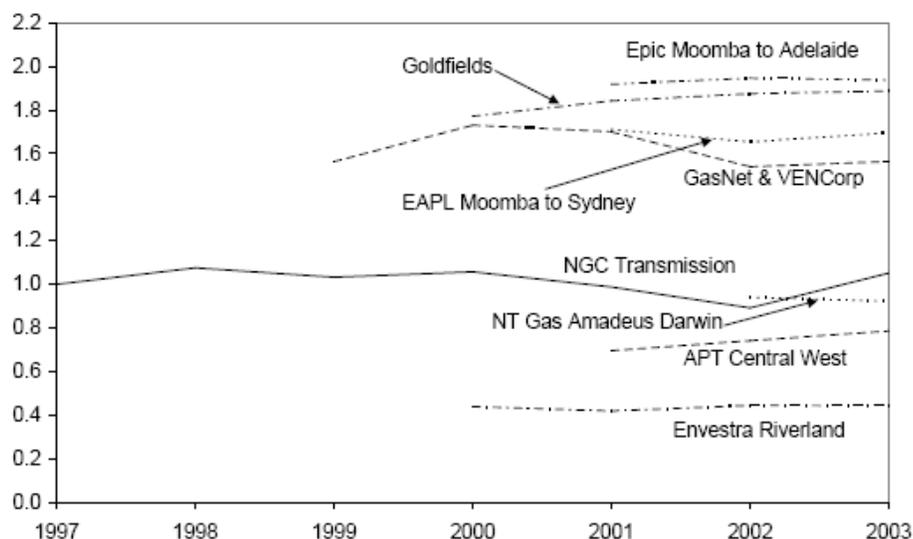
4 Productivity

- The Commission is proposing to adopt a Total Factor Productivity (TFP) approach to identify the long run rate of productivity improvement for suppliers of gas pipeline services. This is then to be used by the Commission, in a non-mechanistic manner, to set the X-factor for the price path under the initial DPP. AECT is familiar with this approach as it was used by the Commission in setting the X-factor in the 1 April 2010 reset of the DPP for EDBs.
- The DPP is intended to be a low-cost regulatory option. Within the constraint reasonably imposed by a low-cost regime, the overarching purpose of the X-factor is to incentivise and share efficiency improvements.
- Some certainty as to the approach for setting the X-factor is important as this enables management to test business decisions aimed at improving productivity against the methodology, and to assess their likely impact in advance of the DPP being reset. The AECT is of the view that any undue complexity in determining the X-factor will hide any underlying signals for productivity improvement. If this occurs, the X-factor will fail to deliver the ongoing productivity improvements sought.
- Uncertainty in the determination of TFP is a concern to the AECT. In assessing the rate of productivity improvement, AECT has a preference for the more traditional TFP approach – as adopted by the Commission in setting the B-factor under the (former) Thresholds Regime for electricity lines businesses. However, in the 2010 reset of the DPP for EDBs, the Commission proposed an amended TFP approach (that takes into account sunk costs and financial capital maintenance) which the AECT did/does not support.
- In retrospect, the Commission had regard to both approaches when setting the X-factor for EDBs. The AECT appreciated this non-mechanistic / pragmatic approach, and supported the resulting X=0 outcome.
- The AECT encourages the Commission to adopt a similarly pragmatic approach in the case of the initial DPP for GPBs. However, as there is no guarantee in the future that the traditional TFP approach and the amended approach will necessarily provide some central ground (e.g. X=0) as was the case with the 2010 X-factor for EDBs, the AECT encourages the Commission to have greater regard to the more traditional B-factor approach.
- Given the smaller number of GPBs in New Zealand compared with EDBs, and the more limited data base of information that can be used to assess industry-wide productivity, AECT broadly supports the Commission's

proposal that, in determining TFP:

- New Zealand gas sector data should be used in the first instance; and, if this is insufficient, then
 - overseas studies of the long-run rate of productivity growth in the gas sector may be used; or
 - productivity from other sectors of the economy may be relied on.
- AECT notes a comparative study of gas sector TFP in Australia and New Zealand. This was undertaken by Meyrick and Associates in 2004⁷. The productivity trends were identified to be as follows⁸:

Figure 21: Transmission total factor productivity index time-series – Model 2



Source: Meyrick and Associates gas utility database

- The above chart suggests that actual productivity differs significantly from one gas transmission business to another. However, for the setting of the X-factor, it is not the actual productivity but the rate of change (trend) in productivity that is important. A cursory review of the chart suggests a closer alignment in trends than in actual rates of productivity. This suggests that overseas productivity trends may be capable of corroborating New Zealand trends.

⁷ Meyrick and Associates; “Comparative Benchmarking of Gas Networks in Australia and New Zealand”; 14 May 2004

⁸ Ibid (p53)

- Given the fairly long timeframe for the setting of the initial DPP, AECT suggests that there is no reason for the Commission not to try and identify robust GPB productivity trends from New Zealand gas sector data.
- In keeping with the Commission's non mechanistic approach to setting the X-factor, the AECT suggests that the Commission should seek to corroborate and/or adjust New Zealand gas sector productivity trends with reference to:
 - productivity trends (using the more traditional B-factor TFP approach) for New Zealand electricity lines businesses (ELBs); and/or
 - overseas productivity trends.

In this regard, the AECT notes that TFP studies for Australian GPBs have been undertaken using the more traditional 'B-factor' approach. The AECT suggests that this is another reason for the Commission to have greater regard to this approach.

- Of these two options for corroborating and/or adjusting New Zealand gas sector productivity trends, the AECT's preference is that the Commission should have reference to productivity trends for New Zealand ELBs.

AECT Recommendation:

- **That the Commission continue to use the previous 'B-factor' approach for identifying the long run rate of productivity improvement.**

5 Other Issues

- The Issues Paper covered several additional matters of interest to the AECT. The AECT has only brief comments to make in relation to these:

a) The Nature of Gas Pipeline Services

- The AECT broadly agrees with the Commission's Issues Paper proposals that there are differences in the nature of gas transmission and gas distribution that warrant separate DPPs for gas transmission and gas distribution businesses. However, as expressed in its 30th April 2010 submission on the form of control, the AECT does not agree with the Commission extending this differential to the form of control. Decisions on the form of control should rest with other factors – which may differ from one business to another – such as revenue drivers and the extent of any ongoing investment in connections and capacity.

b) Quality

- To the extent that it is not practical, feasible, or consistent with the low-cost regulatory option, to integrate price and quality in the initial DPP, then the AECT broadly accepts the Commission's proposals for separate quality standards based on reliability. However, the AECT understands that traditional reliability metrics such as SAIDI and SAIFI are less useful for gas than for electricity – as unplanned 'interruptions' are less frequent in the case of gas and are more reflective of third party events than network condition. AECT suggests that the Commission may need to identify other indicators of reliability – such as Publicly Reported Escapes which is a system integrity measure that may also be seen as a leading indicator of reliability (i.e. network condition), and failure to meet pressure thresholds (in the case of the gas transmission system).
- AECT notes the challenge for the Commission is to set quality standards for which a breach:
 - signals that the legitimate expectations of consumers are not being met; and
 - warrants enforcement action.
- Given the possibility of enforcement action / penalties following a breach, the AECT cautions against the use of 'hard limits' that are based on averaged reliability performance. An average performance metric implies a breach may occur 50% of the time – which is clearly not appropriate for enforcement / penalty purposes.

- Any metrics adopted by the Commission must be thoroughly tested (including statistical testing where appropriate) to avoid ‘technical breaches’. For instance, AECT understands that the standard deviation of SAIDI is likely to be high – as the duration of interruption from an infrequent major event will dominate the minimal duration of interruptions in most years. AECT expects that the Commission would make allowance for considerations of this nature – for example, in the setting of deadbands.
- As alluded to previously, the AECT considers it appropriate for the Commission to adopt different DPP parameters (including quality / reliability standards) for gas transmission and gas distribution. Whilst the AECT does not intend to propose actual standards for the Commission’s consideration it nonetheless fully endorses Vector’s views in this regard.
- AECT also supports the Commission’s initial view that additional quality metrics – such as customer service, gas quality and system integrity – may be monitored outside the DPP. For instance, metrics covering these aspects of quality may be monitored through Information Disclosure.

c) Timing Considerations

- AECT notes that the Commission’s proposals will result in Vector’s compliance reporting being non-aligned with its pricing years. Vector’s pricing year commences 1 October, whilst the Commission’s proposals are based around a compliance year commencing on 1 July.
- The Commission’s proposals will increase compliance costs for Vector. As Vector’s major shareholder, the AECT finds this proposal by the Commission to be unacceptable.
- In terms of its recommendation, AECT fully endorses Vector’s proposal for an alternative regulatory period commencing 1 October 2012.