Submission on

Method to Adjust DPP Starting Prices

From the Electricity Networks Association

10 September 2010

Electricity distribution businesses supporting this submission

The electricity distribution businesses listed below support this submission.

Alpine Energy Ltd
Aurora Energy Ltd
Buller Electricity Ltd
Centralines Ltd
Counties Power Ltd
Eastland Network Ltd
Electra Ltd
Electricity Ashburton Ltd
Electricity Invercargill Ltd
Horizon Energy Distribution Ltd
Mainpower NZ Ltd
Marlborough Lines Ltd
Nelson Electricity Ltd
Network Tasman Ltd
Network Waitaki Ltd
Northpower Ltd
Orion New Zealand Ltd
OtagoNet Joint Venture
Powerco Ltd
Scanpower Ltd
The Lines Company Ltd
The Power Company Ltd
Top Energy Ltd
Unison Networks Ltd
Vector Ltd
Waipa Networks Ltd
WEL Networks Ltd
Wellington Electricity Lines Ltd
Westpower Ltd

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Executive summary

1. This submission is the Electricity Networks Association's (ENA) response to the Commerce Commission's (Commission) paper of 5 August titled "*Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*" (DPP Discussion Paper).

2. The ENA is concerned that the DPP Discussion Paper does not grasp the significance to the orderly implementation of the Part 4 regime of any adjustments to DPP starting prices, and of the method used to effect those adjustments. The proposed method for DPP starting price adjustments would, for the first time, attempt to align regulated price caps for the electricity lines service with the current and projected profitability of EDBs. The proposed method for adjusting DPP starting prices is a very significant step in the implementation of Part 4 and does not have precedent under Part 4A to draw from.

3. The ENA considers the approach set out in the DPP Discussion Paper needs to be improved in four ways. First, the ENA considers Part 4 requires that the method for adjusting DPP starting prices be an input methodology (IM). The ENA sets out its reason for this view in its letter of 23 July to the Commission. Comments in this submission on the Commission's proposed method are on a without prejudice basis to that view.

4. Second, the ENA considers the Commission needs to develop a robust framework within which to develop and assess various possible methods to undertake this task, along the lines of the frameworks the Commission developed for each IM in its IM Draft Reasons papers. The ENA is concerned the absence of the IM disciplines appears to be resulting in a less rigorous approach for what is a critical aspect of the implementation of Part 4. The ENA also considers the development of this method warrants a conference, along the lines used for the development of IMs.

5. Third, the DPP Discussion Paper lacks an evidential basis for choosing the proposed method over other possibilities. Rather the proposed method is put forward in a partially developed form, without comparison to other possibilities, and with wide discretion as to how the Commission will apply the results of any further analysis.

6. Fourth, the time pressure to apply this method for adjusting DPP starting prices appears to be driven by the Commission's intention to reset the current DPP pursuant to section 54K, which allows for a nine-month window for this reset from when the IMs are published. The ENA is concerned this potential reset could unfold as follows:

   - the Commission publishes its IMs in late 2010;

- one or more IMs is appealed within twenty working days of their publication;
- the Commission invokes section 54K and resets the DPP for some EDBs as from April 2012, and may or may not apply claw-back. This reset would need to be gazetted by September 2011 in order to be within the nine month window provided under the section 54K provision (assuming IMs are published in December 2010);
- the IM appeal leads to a change in one or more IMs and those changes result in a materially different DPP for some EDBs; and
- the reset DPP applying to some EDBs from April 2012 is reset a second time, and the Commission (must) applies claw-back, potentially reversing changes from the first reset.

7. The above would be a very untidy and uncertain implementation of the Part 4 regime. To avoid this, the Commission could forego the DPP reset pursuant to section 54K and instead focus on navigating an orderly implementation of Part 4 that anticipates the first DPP reset at the end of the current regulatory period. It is important that short term implementation challenges do not result in methods and outcomes that are found to be inconsistent with the purpose of Part 4 over the longer term.

8. The Commission's proposed method involves testing whether the current and projected probability of an EDB falls within an ROI band, which is proposed to be set in a symmetrical manner about the 75th percentile estimate of WACC. If this band approach is used the ENA considers the purpose of Part 4 would be better met with a ROI band that has a lower limit at or above the 75th percentile estimate of WACC, and that the upper limit is set with reference to the results of appropriate statistical analysis of relevant ROI data.

9. The DPP Discussion Paper raises the issue as to how the proposed method of adjusting DPP starting prices would handle efficiency gains arising from mergers or acquisitions, or those accumulated under the Commission's proposed Incremental Rolling Incentive Scheme (IRIS). The ENA, in its submission on the draft Processes & Rules IM, proposed an extension of IRIS to cover those EDBs on a DPP and efficiency benefits arising from mergers and acquisitions. If this proposal is accepted, it would be straightforward to integrate the resulting disclosed ROIs into the Commission's proposed method for adjusting DPP starting prices.

1. Introduction

10. This submission is the Electricity Networks Association's (ENA) response to the Commerce Commission's (Commission) paper of 5 August titled "*Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*" (DPP Discussion Paper).

11. The DPP Discussion Paper proposes a method for adjusting DPP starting prices at the beginning of a regulatory period in situations where the Commission wishes to set the DPP starting prices at a level different to that prevailing at the end of the previous regulatory period. The Commission envisages using this method for the first time to adjust DPP starting prices as from April 2012. This particular adjustment of starting prices differs from a normal DPP reset in that it would be applied part way through a DPP regulatory period, and that there would be less disclosed information available to support it than is expected for future DPP resets.

12. The DPP Discussion Paper does not address the issues peculiar to the possible April 2012 adjustment but rather focuses on the general method for adjusting DPP starting prices. In this submission we respond to the general method proposed in the Discussion Paper and in addition we raise a number of issues we consider need attention, should any adjustment proceed of DPP starting prices as at April 2012. The submission is structured as follows:

- Section 2 highlights the importance of this method to adjust DPP starting prices within the wider context of the implementation of the Part 4 regime, and some issues of timing and sequencing that this wider context presents.
- Section 3 comments on the Commission's proposed method to adjust DPP starting prices.
- Section 4 addresses other issues related to how efficiency gains would be handled under the proposed method and implications of the final form of the input methodologies (IMs) for these issues.

2. Context and importance of method to adjust starting prices

13. The DPP Discussion Paper does not grasp the significance to the orderly implementation of the Part 4 regime of any adjustments to DPP starting prices and of the method used to effect those adjustments. The proposed method for DPP starting price adjustments would, for the first time, attempt to align regulated price caps with the current and projected profitability of EDBs. This

is in contrast to price thresholds which applied to EDBs under Part 4A, which effectively locked in, as starting prices, the actual (weighted average) published prices for each EDB as at 8 August 2001. Although the price path thresholds were rolled forward with various assumptions regarding inflation, expected changes in productivity and profitability, they were never set with explicit reference to a defined regulatory asset base (RAB) and an estimated weighted average cost of capital (WACC).[1]

14. Thus the proposed method for adjusting DPP starting prices is a very significant step in the implementation of Part 4, and does not have precedent in Part 4A to draw from.

15. The Commission has, quite rightly in ENA's view, invested considerable time and effort to develop and consult on IMs. Likewise the sector has invested hugely in this process. The proposed method to adjust DPP starting prices would be the first application of the IMs to a set of decisions that have direct implications for the level of regulated prices. The ENA considers the DPP Discussion Paper falls well short of the work required to establish a credible method for making such adjustments. We discuss these shortcomings under the following headings:

- the method for adjusting DPP starting prices should be an IM;
- absence of a robust framework and process within which to develop various possible methods for making these adjustments and to assess their relative merits;
- absence of an evidential basis to support the choice of the proposed method; and
- timing and sequencing of the development of this method and its potential application.

This method should be an input methodology

16. In a letter of 23 July 2010[2] to the Commission the ENA set out why it considered the method the Commission uses to adjust DPP starting prices should be developed and determined as an IM pursuant to section 52T of the Part 4. In summary that letter states at page 2:

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[1] For a history of the regulation of EDBs over the last ten years see Appendix 1 of "*Submission 7: Valuation Input Methodology Initial Regulatory Asset Base*" Electricity Networks Association, 20 August 2010

[2] Letter of 23 July 2010 from Alan Jenkins, CEO of ENA, to Mark Berry, Chair of the Commerce Commission.

We consider that the Commission is required under section 52T of the Commerce Act 1986 ("Act") to set out its methodology for setting and adjusting starting prices as an IM determination and that determining this methodology outside the IM process is unlawful In particular:

(a) the methodology for setting and adjusting starting prices and rates of change ("DPP price methodology") is a requirement under section 52T(1)(b) (pricing methodologies) or section 52T(1)(c)(i) (rules and processes);

(b) DPP price adjustments could not be lawfully implemented by the Commission in the current regulatory period in the absence of an IM setting out the starting price methodology; and

(c) notwithstanding (a) and (b) above, sufficient detail of a DPP price methodology is required in order for EDBs to be able to reasonably estimate the effects of this and other IMs on their businesses (section 52T(2)) and for the purpose of input methodologies (section 52R) to be met.

17. The Commission responded in a letter of 30 July[3] that it considered the relevant provisions of Part 4 do not require it to develop and determine its method for adjusting DPP starting prices as an IM, and that it does not intend to do so.

18. The DPP Discussion Paper is much less rigorous in its approach to develop a method for adjusting DPP starting prices than was the consultation material issued by the Commission in relation to the development of IMs. This is of concern – the absence of the IM disciplines appears to be having a direct impact on the way in which the Commission is going about this task.

19. If the Commission continues with its view that this method is not an IM, the result for adjusting starting prices will be:

- if set pursuant to section 53P(3)(a) under a DPP, starting prices will be set with reference to prices that applied at the end of the preceding regulatory period, thus providing a clear and certain process and outcome;
- if set pursuant to section 53P(3)(b), starting prices will be set with reference to a method the Commission is able to change at any time (including part way through its process to reset a DPP if the results do not support the Commission's expectations); and

[3] Letter of 30 July 2010 from Mark Berry, Chair of the Commerce Commission, to Alan Jenkins, CEO of ENA.

- if set pursuant to a CPP application, starting prices will be set as part of the process defined in the CPP IM.

20. It is clear from the above that the proposed method to give effect to the 53P(3)(b) process is aberrant. The ENA considers the Commission must address this by treating this method as an IM.

21. The comments in this submission on the DPP Discussion Paper are provided on a without prejudice basis to ENA's view that the Commission is required under Part 4 to treat its method to adjust DPP starting prices as an IM.

Absence of a robust framework and process

22. In its IM Draft Decisions papers the Commission sets out, for each topic, the scope of the decision, a decision making framework (referenced to the relevant purpose statements), an overall approach, the components of the methodology, and implementation of the methodology. While some (but not all) of these headings are in the DPP Discussion Paper there is little of substance on each topic relative to that provided in the IM Draft Decisions papers.

23. For example, section 53P(3)(b) requires that starting prices *"are based on the current and projected profitability of each supplier"*. Thus defining these measures of profitability and identifying possible ways to quantify them is central to the task of developing this method. However the Commission in the DPP Discussion Paper doesn't define what it understands to be "current and projected profitability", and doesn't seriously consider possible ways of quantifying these profitability measures other than by reference to historical ROIs. Thus "current and projected profitability" is equated to historical measures of profitability in the form of reported ROIs.

24. While historical ROIs may form a part of any quantification of these profitability measures, there is no evidence or comparative analysis in the DPP Discussion Paper to provide the basis for determining that historical ROIs should be the only input into quantifying the "current and projected profitability" measures.

25. Another aspect missing in the DPP Discussion Paper relative to the IM papers is interpretation of how best to manage uncertainty, given the purpose of Part 4. In the cost of capital draft IM the Commission recognises the asymmetrical economic effect of under versus over-estimating WACC, and proposes to take the 75th percentile of the WACC estimate to account for this asymmetrical effect. The ENA, in its submission on the cost of capital IM,[4] contends that

[4] *Submission 6: Cost of Capital Input Methodology*, Electricity Networks Association, 13 August 2010

the purpose statement (and other guidance such as the Infrastructure GPS) places an obligation on the Commission to ensure its cost of capital IM results in a WACC estimate that is at or above its true value.

26. This issue of asymmetrical economic effects has its analogue in relation to adjusting DPP starting prices in terms of the uncertainty in quantifying current and projected profitability measures. However, the DPP Discussion Paper does not apply the logic of the cost of capital IM to this issue. We discuss how best to handle this uncertainty in section 3 below, in relation to the design of a band about a WACC point estimate.

27. Lastly, the IM consultation process included a conference and a workshop. The DPP Discussion Paper does not signal either of these interactive forums, which in the ENA's view is an important part of developing a method of this significance. The ENA requests the Commission include a conference in the development of this method.

Absence of an evidential basis

28. In the DPP Discussion Paper the Commission proposes to use historical ROIs (and no other information inputs) to quantify the current and projected profitability measures. It indicates it may normalise the annual ROI data and use statistical analysis to determine the width of the band (paragraphs 4.18 – 4.21). However, it appears this work has yet to be undertaken, and it is not clear how the results will be translated into bands (e.g. in paragraph 4.20 the Commission indicates it may not be appropriate to mechanistically apply the results of quantitative analysis and that it may need to cap the width of the band).

29. Thus at this stage the Commission is proposing a single method to adjust the DPP starting prices without evidence that it will work, without having undertaken the necessary analysis to determine appropriate bands to take account of the statistical uncertainty of this method, and retaining such a large degree of discretion in the application of any statistical analysis to render the description of the method potentially meaningless.

30. The ENA considers at this early stage in the development of this method the Commission should consider a range of possible methods and assess them in terms of their ability to meet the requirements of the purpose of Part 4. The choice of method needs to be based on the evidence derived from this assessment.

Timing and sequencing

31. The time pressure on the Commission to develop and apply this method for adjusting DPP starting prices (given that the Commission does not accept it

should be an IM) appears to be driven by the Commission's intention to undertake a reset of the current DPP pursuant to section 54K, which allows for a nine-month window for this reset from when the IMs are published.

32. Once the IMs have been determined the Commission intends to consult on and implement a revised set of information disclosure requirements (IDR). Given the draft IM determinations, these changes would include changes to the way regulatory tax is reported, modifications to the RAB to reflect corrections to the 2004 ODV, and possible new common cost allocations to non-regulated activities. If the ENA recommendations are accepted this list of changes would include undertaking a fresh 2010 ODV and removing capital contributions from revenue (and offsetting these amounts against the relevant assets). Either way there will be significant changes to the compilation of the current ROIs.

33. Until disclosed ROIs are revised to reflect the IMs, they are not fit for purpose for use as part of any method to adjust DPP starting prices. If the Commission uses a method for adjusting DPP starting prices along the lines of that proposed in the DPP Discussion Paper, it won't have the data to design the method (e.g. to set the width of the band) until the disclosed ROIs are revised. The ENA expects it would take at least three to four months to revise the 2009/10 disclosed ROIs to align with the IMs, depending on the final form of the IMs.

34. Another potential complication would arise if one or more of the published IMs are subject to a merits appeal pursuant to section 52Z. If this occurs the following sequence could unfold:

- the Commission publishes its IMs in late 2010;
- one or more IMs is appealed within twenty working days of their publication;
- the Commission invokes section 54K and resets the DPP for some EDBs as from April 2012, and may or may not apply claw-back. This reset would need to be gazetted by September 2011 in order to be within the nine month window provided under the section 54K provision (assuming IMs are published in December 2010);
- the IM appeal leads to a change in one or more IM and those changes result in a materially different DPP for some EDBs; and
- the reset DPP applying to some EDBs from April 2012 is reset a second time, and the Commission (must) applies claw-back, potentially reversing changes from the first reset.

35. The above would be a very untidy and uncertain implementation of the Part 4 regime. The ENA recognises the Commission is required to work within the constraints of legislation but nevertheless it has the freedom to avoid the above

sequence. For example, the Commission could decide to forego the DPP reset pursuant to section 54K and instead focus on navigating an orderly implementation of Part 4 that anticipates the first reset at the end of the current regulatory period. An alternative sequence along these lines would be:

- the Commission publishes its IMs in late 2010;
- one or more IM is appealed within twenty working days of their publication;
- the Commission revises and consults on the IDRs to align them with the IMs;
- once the outcome of any appeals is known, any necessary changes are made to the IDRs, and EDBs report against these requirements; and
- the revised IDRs result in a dataset prepared on a consistent basis for the 2009/10 – 2012/13 period, which could be used as an input to quantify the "current and projected profitability" measures as part of the DPP reset to apply as from April 2015.

36. The timing and sequencing of the implementation of Part 4 presents significant challenges in the short term. It is important these short term challenges do not result in methods and outcomes that are found to be inconsistent with the purpose of Part 4 over the longer term.

37. As a final, but very important point relating to timing, EDBs are likely to embark on a thorough review of structural resilience in the wake of the Christchurch earthquake, while those that suffered damage will face immediate remedial costs. This context heightens the need for regulatory certainty to support this work. Unless the starting price adjustment methodology is recognised as an IM, and developed with appropriate rigour, the prospect of a loosely defined method to adjust DPP starting prices based solely on historic measures of profitability will undermine that certainty.

3. Comments on Commission's proposed method

38. The DPP Discussion Paper sets out a proposed method for adjusting DPP starting prices which involves the following steps:

- assess the ROI of each supplier using historical ROI data;
- normalise the historical ROI of each supplier to account for one-off events where appropriate;
- compare each supplier's ROI(s) to an ROI band centred on an industry WACC with the WACC estimate to be set equal to the 75th percentile of

the vanilla WACC range. This band is to allow for uncertainty in the Commission's estimate of an EDB's current and projected profitability;

- for EDBs with a profitability estimate above the upper limit of the ROI band, adjust prices downwards such that their estimated level of profitability is at the upper limit of the ROI band;
- for EDBs with a profitability estimate below the lower end of the band, adjust prices upwards such that their estimated level of profitability is at the lower limit of the ROI band; and
- for EDBs with profitability estimates that fall within the band, make no change to starting prices.

39. In order to determine the ROI band, it is proposed that a historical time series of ROI data will be used (where this exists in a consistent format) to examine the variation in the components of the ROIs. This is to be undertaken using statistical analysis, although paragraph 4.20 of the DPP Discussion Paper signals that this will not be applied mechanistically, and the Commission may cap the limits on the band (but has not indicated the basis on which such judgments will be made). In addition it is the intention for the band to be symmetrical about the WACC point estimate.

Design of a band

40. If the Commission proceeds with its proposed approach it will be necessary to develop a method to translate historical ROIs into estimates of current and projected profitability. A ROI band is one means of achieving this. In the following paragraphs we explore the possible rationale for setting the upper and lower limits of a ROI band.

Symmetrical band inconsistent with purpose of Part 4

41. Under the proposed method suppliers with ROI estimates which fall below the lower limit of the proposed ROI band would be restricted from increasing their prices under the DPP above the lower limit of the band. Thus they would be prevented from earning, ex ante, normal returns. The ENA submits that this is inconsistent with the purpose of Part 4 and in particular parts (1)(a) & (b) of the section 52A Purpose Statement. The purpose of Part 4 (section 52A) reads:

> *(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.

42. By restricting suppliers from earning normal rates of return the DPP would not provide sufficient incentives to suppliers to invest in the infrastructure required to provide regulated services. This is an important limb of the purpose statement which was specifically introduced by Parliament into Part 4 consistent with the 2006 GPS on infrastructure investment. Unless suppliers of regulated services have incentives to invest sufficiently in long term infrastructure, it is not possible for them to provide regulated services in a manner consistent with promoting the long term benefits of consumers. In addition, unless limb (a) is met, it is not possible to achieve limb (b), to improve efficiency or provide services at a quality that meets consumer demands, or limb (c) to share efficiency gains with consumers.

43. The proposal is also inconsistent with limb (d) which requires the regime to limit the ability of suppliers to extract excessive profits. Limb (d) does not require the Commission to limit profits to subnormal levels. Indeed, paragraph 4.13 of the DPP Discussion Paper indicates that the Commission considers that it is appropriate to err on the side of caution when setting the WACC estimate for this purpose given the uncertainty in estimating WACC[5] (and to use the 75th percentile to achieve this). The same logic applies to designing the ROI band to handle the uncertainty in the estimate of current and projected profitability.

44. The ENA submits that it is inconsistent with the purpose statement for the method to adjust DPP starting prices to result in a supplier's expected returns to be constrained below the WACC point estimate. Accordingly, the lower limit of the ROI band should be set at no less than the 75th percentile of the WACC estimate. This would enable those EDBs which have current and projected profitability levels below the WACC point estimate to increase their prices such that their expected profitability is at least at the WACC point estimate.

Upper limit of band

45. Consistent with the DPP Discussion Paper, the ENA recognises the practical difficulties in deriving current and projected profitability from historical ROIs. Accordingly, if a band approach were to be adopted as a means of allowing for

[5] Which is explained in more detail in the Commission's Draft Reasons Paper which supports the draft Cost of Capital IM, 18 June 2010

the uncertainty in these profitability measures, the upper limit of the ROI band should be set above the 75th percentile WACC estimate. As outlined above the ENA submits that the lower limit of the band should be no less than the WACC 75th percentile point estimate.

46. This approach would be consistent with the purpose of Part 4, which requires regulated suppliers to have incentives to invest, and be limited in their ability to extract excessive profits. It is also consistent with the requirement for suppliers to have incentives to improve efficiency, by allowing those within the band to move towards the upper end of the band and retain the benefits achieved into the next regulatory period.

47. The proposal in the DPP Discussion Paper to undertake statistical analysis of variations in historical ROIs in order to explore how a band may be determined is worthy of further investigation, although we have concerns about elements of the proposed approach, in particular:

- the intention of the Commission to potentially adjust the outputs of the statistical analysis in some way;
- the intention to consider only variances in opex, when ROI is influenced by a number of factors including demand, discounts and rebates, non-line charge revenues (e.g. connection charges and capital contributions), recovery of pass through costs, revaluations, capex and depreciation; and
- the potential use of the historical ROI series that does not reflect the IMs.

48. The ENA does not believe this proposed statistical analysis is a simple exercise. The way this proposed analysis is presented in the DPP Discussion Paper leaves the Commission wide discretion as to how it interprets and uses results of any such analysis; this adds to the ENA's contention that this method must be developed and determined as an IM.

49. The ROIs disclosed by EDBs in years 2007/08, 2008/09 and 2009/10 are appended, to provide them in accessible form in one table. These ROIs were compiled pursuant to consistent information disclosure requirements but obviously do not reflect changes that will arise from the application of the IMs. The ENA notes that over this three year period the sum of all denominators used in the ROI calculations (i.e. the disclosed regulatory investment value) were $7.4 billion, $7.9 billion, and $8.4 billion in each year respectively.

4. Other Issues

Treatment of Efficiencies

50. Section 5 of the DPP Discussion Paper sets out a proposed approach for the treatment of certain efficiencies in the context of adjustments to DPP starting

prices. These include efficiencies that may arise as a result of mergers and acquisitions, and efficiencies which may have accumulated under the Incremental Rolling Incentive Scheme (IRIS) which is proposed to be included as part of the Processes and Rules IM for CPPs.

51. We note that the IMs have not yet been finalised and recent submissions from interested parties have suggested a number of amendments to the Commission's draft determinations, including proposed amendments to the IRIS component of the Processes & Rules IM. Accordingly the ENA submits that the discussion in Section 5 is somewhat premature as many of the issues raised in this section could be addressed by the modifications to IRIS as recommended by the ENA.

52. We also note that Section 5 does not distinguish between adjustments to DPP starting prices in the existing DPP, and those which may be made for subsequent regulatory periods. As the current DPP was initially implemented prior to the IM determinations, it is likely that recognition (if any) of efficiencies in adjustments to those DPP starting prices may need to be determined using a different process to that which is applied in subsequent DPP resets. This issue is not explored in the DPP Discussion Paper.

53. It is proposed that the ROI data to be used to assess adjustments to DPP starting prices will incorporate an average annual merger and acquisition cost (to be derived from the previous five years opex for each EDB) where merger activity is related to regulated services. The intention is for suppliers to share the costs of transaction activity with consumers as well as the benefits. The ENA notes this differs from existing disclosed ROIs, as merger and acquisition expenses are excluded from this measure at present.

54. In terms of sharing efficiency gains with consumers, any efficiency gains which are achieved in any regulatory period, and which result in a ROI above the upper ROI band at the reset (in accordance with the proposed starting price adjustment method) are to be shared with consumers at the reset (i.e. prices will be reduced to the ROI band). Any further efficiency gains which may be achieved in subsequent regulatory periods may be retained for that period, but will be shared with consumers at the following reset, if the ROI at that time exceeds the upper ROI band.

55. Assuming efficiency gains push a supplier's ROI above the upper ROI band by the end of each regulatory period, the maximum period a supplier would be able to retain the benefit of the efficiency gains is five years. However this period would only apply to gains made at the start of a regulatory period. Accordingly in practice efficiency gains would be retained for less than five years under the DPP.

56. In responding to the IM Draft Reasons paper, the ENA submitted that:

- the IRIS should be extended to the DPP; and
- the IRIS should allow for efficiency gains from merger activity to be retained for a period of ten years (not five) to ensure such rewards are commensurate to the risks involved and reflect the period over which benefits can in practice be achieved. [6]

57. By extending the IRIS to the DPP, incentives for efficiency gains would be available to all non exempt EDBs, not just to those subject to a CPP. This is consistent with the purpose of Part 4, and as stated in ENA's Submission 5, is a materially better approach than that proposed by the Commission. The ENA's submission on the mark ups to the IM Draft Determinations sets out how our proposed changes could work in practice.[7] We have not repeated the detailed proposals for the purpose of this submission but refer the Commission to our recent submission which outlines how this could work for the DPP.

58. We also note that it is intended that any benefits achieved under a CPP, which form part of IRIS and which have not been fully retained for five years at the end of the CPP period, are to transition to the DPP. We support this proposal, however consistent with ENA's Submission 5 we submit that where these benefits arise from a merger an EDB should be able to retain them for ten years, not just five.

Mergers between regulated suppliers

59. The DPP Discussion Paper does not address how mergers or transactions between regulated suppliers will be accommodated in the method to adjust DPP starting prices (other than in respect of efficiency gains). The ENA responded to the Commission's proposals for merging CPPs and DPPs in the context of the Processes & Rules IM. We refer the Commission to the ENA's Submission 5 and Submission 10 on the IMs in this respect and suggest that these issues need to be resolved first in the context of the IMs before it is possible for the ENA and others to engage usefully on their implications for a method to adjust DPP starting prices.

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[6] Refer *Submission 5, Processes and Rules Input Methodology*, Electricity Networks Association, 9 August 2010

[7] Refer *Submission 10, Input Methodologies Draft Determinations Parts 1-4, Part 3 Subpart 4*, Electricity Networks Association, 25 August 2010

Appendix – ROIs 2008 - 2010

The table below sets out the Return on Investment (ROI) disclosed by EDBs for years 2007/08, 2008/09, and 2009/10. It is noted these ROIs reflect current information disclosure requirements and therefore do not reflect the IMs that have yet to be published.

Disclosed ROI (%)	2008	2009	2010
Alpine Energy	10.13	11.12	8.01
Aurora Energy	12.40	11.49	9.70
Buller Electricity	4.83	7.25	7.28
Centralines	4.73	6.15	6.22
Counties Power	10.56	7.29	4.52
Eastland Network	9.25	9.26	8.16
Electra	3.79	3.15	1.98
Electricity Ashburton	7.55	8.76	7.32
Electricity Invercargill	10.07	8.80	7.83
Horizon Energy Distribution	9.17	11.09	9.44
MainPower New Zealand	10.46	10.17	7.15
Marlborough Lines	5.98	5.52	3.41
Nelson Electricity	11.02	12.64	8.62
Network Tasman	9.29	9.48	8.64
Network Waitaki	9.15	8.57	8.07
Northpower	11.64	7.46	6.79
Orion New Zealand	10.09	10.02	8.60
OtagoNet Joint Venture	11.51	11.23	9.40
Powerco	10.83	11.23	9.36
Scanpower	10.27	8.76	7.04
The Lines Company	8.25	6.12	6.03
The Power Company	7.62	7.57	5.59
Top Energy	7.77	7.05	4.72
Unison Networks	10.13	8.95	8.93
Vector	11.80	11.60	10.35
Waipa Networks	11.50	9.45	9.09
WEL Networks	13.78	12.22	10.95
Wellington Electricity Lines	n/a	8.63	11.49
Westpower	10.41	6.94	5.30