

**COMMERCE COMMISSION**

**Regulation of Electricity Lines Businesses**

**Targeted Control Regime**

**Reasons for Not Declaring Control**

**Unison Networks Limited**

**11 May 2007**

# CONTENTS

	Page
<b>Executive Summary</b>	<b>3</b>
<b>1 Introduction</b>	<b>14</b>
Purpose and Scope	14
Statutory Framework and Process	16
<b>2 Background to Unison's Settlement Offer</b>	<b>26</b>
Unison Networks Limited	26
Unison's Breaches of the Thresholds	27
Evaluation of Unison's Pricing Behaviour	29
Post-Breach Inquiry into Unison's Performance	30
Unison's Initial Administrative Settlement Offer	31
Judicial Review Proceedings	31
Decision to Publish an Intention to Declare Control	33
Unison's Revised Administrative Settlement Offer	37
<b>3 Framework for Evaluating Administrative Settlements</b>	<b>40</b>
Statutory Interpretation	40
Basis for Not Declaring Control	43
Relevant Factual and Counterfactual for Evaluating Settlement Offers	43
Net Benefits of Accepting and Implementing a Settlement Offer	44
Views of Interested Parties	46
Summary	48
<b>4 Evaluation of Unison's Settlement Offer</b>	<b>50</b>
Overview of Unison's Revised Offer	50
Aggregate Pricing Proposals	51
Disaggregated Pricing Proposals	51
Investment Proposals	56
Quality Proposals	59
Net Benefits Assessment	60
Views of Interested Parties	65
Summary	74
<b>5 Decision Not to Declare Control</b>	<b>77</b>
Decision Not to Declare Control of Unison	77
Next Steps	78

## EXECUTIVE SUMMARY<sup>1</sup>

- 1 The Commerce Commission (Commission) has received an administrative settlement offer from Unison Networks Limited (Unison) that includes undertakings concerning Unison's future performance. Unison's offer (dated 31 August 2006, as amended on 13 September and 18 October 2006) followed the publication in the *New Zealand Gazette* of the Commission's intention to make a declaration of control in respect of the electricity distribution services supplied by Unison, under the "targeted control regime" set out in Part 4A of the Commerce Act 1986 (the Act).
- 2 The purpose of this paper is to set out the Commission's reasons for deciding not to declare control in respect of Unison's distribution services, and why it has accepted Unison's administrative settlement offer. This decision follows the Commission seeking the views of interested parties on its draft reasons for not declaring control, which were issued in November 2006 (Draft Decision Paper). Acceptance of Unison's settlement offer—through a Settlement Deed that incorporates the terms of that offer—means that the Commission can close its post-breach inquiry into Unison's past threshold breaches, and can therefore publish its reasons for not making a control declaration in the *Gazette*, in accordance with s57H(d)(ii) of the Act.
- 3 Unison's administrative settlement offer involves the company voluntarily reducing its average prices from 1 December 2006 to comply with its existing "price path threshold", which was set by the Commission for a five-year regulatory period from 1 April 2004 to 31 March 2009. Unison's offer also involves rebalancing its line charges to different regions and customer groups, so that the prices paid by consumers better reflect the costs of supplying them. The administrative settlement offer was publicly released along with the Commission's Draft Decision Paper, in order that interested parties could provide their views.
- 4 The Commission's price path threshold represents the average price increases that distribution businesses like Unison can make annually, thereby limiting the ability of the businesses to earn excessive profits while also providing strong incentives for improved efficiencies. The price path threshold reflects expected industry-wide improvements in efficiency, and therefore some efficiency gains are shared with consumers *during* the regulatory period.
- 5 More significantly however, businesses have an incentive to outperform the efficiency expectations implied by their price path threshold because, during the regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their price path. This, in turn, increases the level of benefits that are potentially available to be shared with consumers from the *end* of the regulatory period (i.e., when the thresholds are reset in 2009).

---

<sup>1</sup> This Executive Summary is provided for the assistance of readers of the Commission's decision not to declare control in respect of the electricity distribution services supplied by Unison Networks Limited (Unison). It does not purport to completely encompass all details of the Commission's investigation and analysis undertaken as part of its post-breach inquiry into Unison, the reasons for the Commission's decision or the decision itself. Readers are referred to the body of this document for the full analysis, reasoning and conclusions.

- 6 In the Commission's view, Unison's existing thresholds provide an appropriate level of incentives for efficient behaviour over the regulatory period, and therefore the company did not need to raise its prices further and breach the price path threshold. Given that Unison has now agreed to address the performance concerns identified by the Commission, it is appropriate for Unison's existing thresholds to be retained. In complying with its existing thresholds and the terms of the administrative settlement, Unison's performance during the settlement period will likely be consistent with the objectives of the targeted control regime. Consequently, the objectives of the regime can be achieved without needing to resort to a declaration of control, provided the settlement is implemented.

***Net benefits of accepting and implementing Unison's settlement offer***

- 7 The Commission considers that the following net benefits to consumers will be realised from accepting and implementing Unison's administrative settlement offer:
- Unison's compliance with its existing thresholds, and its commitment to addressing the performance issues identified in the Commission's intention to declare control, will ensure behaviour consistent with the regime's objectives at a lower administrative and compliance cost than control;
  - in particular, Unison's incentives to invest in order to maintain network performance will be preserved over the settlement period, as is evidenced by the company's commitment to meeting its capital expenditure targets;
  - Unison's tariff rebalancing programme will likely provide allocative efficiency benefits in a less intrusive and costly manner than would be possible under control;
  - any forgone short-term benefits to Unison's consumers, from potentially lower prices under control, are likely to be more than offset over time by the benefits arising from allowing Unison to retain any additional efficiency gains it makes over the settlement period, because this increases the level of benefits available to be shared with its consumers when the thresholds are reset in 2009;
  - positive impacts on investment incentives for the wider industry will likely stem from the regulatory stability signals provided by the Commission in reinforcing its commitment to a medium-term price path;
  - with any settlement there is a possibility of non-compliance, but the Commission considers it will be straightforward to monitor the implementation of the settlement, and if Unison contravenes any of the provisions of the Settlement Deed, the Commission may in its discretion enforce the Deed in the manner and form that it considers appropriate; and
  - Unison's asset management plans, capital and maintenance expenditure, and its reliability performance, will also be subject to regular reviews by the Commission.

**Background to Unison's Settlement Offer**

***Targeted control regime***

- 8 Part 4A of the Act establishes a targeted control regime for all 28 electricity distribution businesses (including Unison) as well as Transpower New Zealand

Limited. Unlike regulatory regimes for electricity lines businesses in overseas jurisdictions, businesses are not automatically subject to control of their prices, revenues and/or service quality. Lines businesses are only potentially subject to control if they have breached one or more performance thresholds set by the Commission.

- 9 The overall purpose of the targeted control regime is to promote the efficient operation of electricity distribution and transmission markets for the long-term benefit of consumers. There are three key steps to the targeted control regime. The first is for the Commission to set performance thresholds for all lines businesses; the second is for the Commission to identify businesses that breach those thresholds; and the third is for the Commission to determine whether or not to control particular services supplied by identified lines businesses. In exercising its statutory powers under Part 4A, the Commission must also have regard to the recent government policy statement (GPS) relating to the incentives of regulated businesses to invest in infrastructure.
- 10 A breach of the thresholds enables the Commission to investigate the recent, current and future performance of an identified lines business. This “post-breach inquiry” is directed at determining whether the performance of the lines business is consistent with the specific objectives of the regime—namely, that the business is limited in its ability to earn excessive profits, faces incentives to improve efficiency and to provide services at a quality that reflects consumer demands, and shares the benefits of efficiency gains with consumers, including through lower prices. Should the performance of the identified business not be consistent with these objectives and the long-term benefit of consumers, then the Commission will need to decide whether control would be necessary for the objectives of the regime to be achieved.

### *Administrative settlements*

- 11 The Commission has indicated that it may be possible for a breach of the thresholds to be resolved by an “administrative settlement”, which would involve an identified business voluntarily reaching an agreement with the Commission on an appropriate course of action. If, possibly following consultation with interested parties, the Commission and a lines business agree on a settlement, then the Commission would cease its inquiry and publish its reasons for not declaring control—referring to the terms of the settlement.

### *Unison Networks Limited*

- 12 Unison is the fourth largest distribution business in New Zealand, measured by either system length, consumer connections, or regulatory asset value. The company is 100% owned by the Hawke’s Bay Power Consumers’ Trust (HBPCT). The HBPCT is an elected body which acts on behalf of the consumer beneficiaries of Unison, namely those consumers connected to Unison’s network in the Hawke’s Bay region. Unison also owns and operates distribution networks in the Rotorua and Taupo regions, which were acquired in November 2002 as part of the sale of a number of networks that had been previously owned by UnitedNetworks Limited (UNL). Consumers in Rotorua and Taupo are not beneficiaries of the HBPCT.

### *Unison's breaches of the thresholds*

- 13 The Commission set its initial thresholds for distribution businesses from 6 June 2003, and these were reset for a five-year regulatory period on 1 April 2004. The thresholds comprise a price path threshold and a quality threshold.
- 14 The price path threshold allows businesses to increase their average distribution prices each year, without breaching the threshold, by the consumer price index (CPI) less an "X factor". It is conceptually similar to the CPI-X incentive mechanisms that regulators commonly use in overseas jurisdictions. Setting a CPI-X price path recognises that distribution businesses face inflationary and other increasing cost pressures, but it also places incentives on businesses to improve their efficiencies in real terms by X percent each year. For the initial thresholds, all distribution businesses were set an X factor equivalent to the CPI. For the reset thresholds, X factors were assigned to distribution businesses on the basis of their relative efficiency and relative profitability, ranging from +2% to -1%.
- 15 Unison was assigned an X factor of 0%, meaning that—had it not already increased prices in 2002—the company could have increased its average prices by the CPI for the five years from 1 April 2004, without breaching the reset price path threshold. However, Unison breached the price path threshold at all four assessment dates (i.e., 6 September 2003, and 31 March of each year from 2004 to 2006), as a result of price increases on 1 April 2002 by around 10% on average to Hawke's Bay consumers, as well as due to price increases on 1 March 2004 by about 6% on average for Rotorua and Taupo consumers, and by about 22% on average for Hawke's Bay consumers.
- 16 The quality threshold requires distribution businesses to demonstrate no material deterioration in reliability, measured in terms of SAIDI and SAIFI, as well as meaningful engagement with consumers to determine their demand for service quality. Unison breached the SAIDI criterion at the second and third assessment dates, and breached the SAIFI criterion at the third and fourth assessment dates.

### *Intention to declare control of Unison*

- 17 As a result of reviewing information obtained from Unison following its breaches of the initial thresholds, the Commission initiated a post-breach inquiry into the company's current and planned performance. Subsequently, in February 2005, Unison submitted an administrative settlement offer to the Commission (Initial Offer), and suspended its planned price increases scheduled for 1 April 2005.
- 18 On 9 September 2005, after having reviewed Unison's Initial Offer as well as other information supplied by the company, the Commission published its intention to declare control of Unison (the Intention Paper). On the basis of the analysis presented in the Intention Paper, the Commission concluded that control of the distribution services supplied by Unison would be consistent with the objectives of the targeted control regime. In particular, the evidence before the Commission was that:
  - Unison had been and was continuing to extract excessive profits from consumers;

- in the absence of price control, Unison would continue to earn excessive profits, whereas control would limit Unison's ability to extract excessive profits in the future;
- Unison had been earning significantly higher returns from its Rotorua and Taupo consumers, which are not beneficiaries of the HBPCT, than from HBPCT consumer beneficiaries in Hawke's Bay;
- in the absence of price control, Unison would continue to earn significantly higher returns from Rotorua/Taupo consumers than from Hawke's Bay consumers;
- there would be long-term benefits to consumers following the imposition of control, primarily resulting from prices lower than they would be without control; and
- benefits of control would likely accrue more to Unison's Rotorua/Taupo consumers, but would nevertheless also be favourable to Hawke's Bay consumers.

- 19 The Commission received submissions from a range of interested parties on its Intention Paper, held conference sessions in Wellington, Rotorua, Taupo and Napier, and received cross-submissions following the conference.

#### ***Revised settlement offer of September 2006***

- 20 On 1 April 2006, Unison reversed its March 2004 distribution price rises to consumers in Rotorua and Taupo. Unison's move was an interim measure that resulted in the Commission delaying its decision whether to place the company's electricity distribution services under control. That delay gave Unison time to prepare a revised administrative settlement offer for consideration by the Commission.
- 21 Following subsequent dialogue between the Commission and Unison, on 1 September 2006 Unison provided the Commission with its revised administrative settlement offer, dated 31 August 2006, for a settlement period ending on 31 March 2009. A number of minor amendments to the offer, relating to the timing of proposed tariff changes, were made through subsequent correspondence from Unison to the Commission (the Revised Offer).

### **Evaluation of Unison's Settlement Offer**

#### ***Aggregate pricing proposals***

- 22 The Revised Offer states Unison's commitment to voluntarily implementing tariff changes on 1 December 2006 and 1 April 2007 to a level that would result in compliance with its existing price path threshold as at 31 March 2007, had those tariffs applied from 1 April 2006. A subsequent tariff review as at 1 April 2008, and if necessary consequential tariff changes, will likewise be undertaken to maintain compliance with the company's existing price path threshold. The settlement period lasts until 31 March 2009, so that at the time of the 2009 threshold reset Unison can be assessed in the same manner as any other distribution business.

*Pricing proposals by region and customer group*

- 23 In its Revised Offer, Unison indicates that it will rebalance tariffs between regions and customer groups in accordance with the allocation of costs in Unison's new Cost of Supply model, thereby resulting in consistent rates of return contributed by each customer group in each regional network. The cost-reflective pricing principles underpinning Unison's new Cost of Supply model are largely derived from the 2005 issues paper prepared by the industry-led Prices Approaches Working Group (PAWG). Similarly, Unison's cost allocation methodology generally follows the key steps outlined by PAWG, although not all the same cost drivers are used. The Commission considers that the principles and assumptions underpinning Unison's new Cost of Supply model are reasonable given Unison's current circumstances.
- 24 Unison's Cost of Supply model undertakes regional cost allocation on the basis of two regions: Hawke's Bay and Rotorua/Taupo. Unison proposes treating Rotorua and Taupo as a single region because, among other things, Unison's development plans include strengthening the contiguity of the two network areas. The reduction in charges to Rotorua and Taupo consumers that Unison implemented from 1 April 2006 resulted in an average \$40/ICP (i.e., \$/connection) fall in charges in Rotorua, and a \$46/connection fall in Taupo. Regional tariff rebalancing consistent with Unison's new Cost of Supply model results in a further reduction of \$14/ICP on average in Rotorua/Taupo, and \$1/ICP on average in Hawke's Bay.
- 25 The Commission notes that the average reductions from the price changes already made by Unison, combined with the further changes implemented as part of the Revised Offer, are not as sizeable as the potential price impacts of control presented in the Intention Paper. Reasons for this difference include the following:
- the regional revenue data that Unison had previously provided to the Commission were incorrect, and therefore the disparities in the Hawke's Bay, Rotorua and Taupo returns were not as significant as that suggested by the Intention Paper;
  - Unison has since provided evidence to the Commission that its capital and operating expenditure projections should both increase by more than 20% (see below); and
  - a price path which is acceptable as part of a settlement should not be seen as indicative of the price path the Commission might allow if a settlement cannot be agreed and control is imposed. (While the Commission might seek to share past efficiency gains with consumers sooner under control than under a settlement, the Commission cannot pre-determine the form and nature of control, and the terms of any authorisation under Part 5 of the Act would be subject to further consultation).
- 26 Unison has retained five customer groups in both Rotorua/Taupo and Hawke's Bay, namely: unmetered, mass market, small commercial, large commercial, and industrial. Notwithstanding that the average price movement in the two regions is a reduction, some customer groups faced increases, whereas other groups have received reductions significantly greater than the average (as is shown in the table below). For example, the most significant price reduction is for large commercial consumers in Rotorua/Taupo (i.e., down \$7,563 for the current year, or 36.8%). While the Revised



Offer and the Commission's Draft Decision Paper were being consulted on, Unison went ahead and implemented all the proposed price changes on 1 December 2006, with the exception of changes for the mass market and large commercial customer groups in Rotorua/Taupo, which were subsequently implemented on 1 April 2007.

**Estimated Average Tariff Changes \***  
(from changes made by Unison on 1 December 2006 and 1 April 2007)

<b>Customer Group</b>	<b>Rotorua/Taupo</b>			<b>Hawke's Bay</b>			<b>Total Unison</b>		
	<b>\$/ICP</b>	<b>c/kWh</b>	<b>Change</b>	<b>\$/ICP</b>	<b>c/kWh</b>	<b>Change</b>	<b>\$/ICP</b>	<b>c/kWh</b>	<b>Change</b>
Unmetered	110	0.2	+3.1%	-398	-1.8	-22.9%	-323	-1.1	-16.1%
Mass market	9	0.1	+2.4%	-33	-0.4	-7.5%	-16	-0.2	-3.9%
Small Commercial	64	0.2	+4.2%	632	1.1	+39.4%	242	0.6	+15.7%
Large Commercial	-7,563	-0.9	-36.8%	2,565	0.4	+19.6%	-1,011	-0.1	-6.4%
Industrial	0	0.0	0.0%	0	0.0	0.0%	0	0.0	0.0%

\* % changes are to the *distribution* component of allocated revenue (i.e., excluding transmission charges)

***Investment proposals and 2006 asset management plan review***

- 27 The Intention Paper did not raise any specific concerns in respect of Unison's planned capital expenditure. However, the Commission is mindful that—under either control or a settlement—the business in question should, on the one hand, be able to undertake a level of investment consistent with providing distribution services at a quality that reflects consumer demands and, on the other hand, be accountable for making that level of investment. Therefore, as part of evaluating Unison Revised Offer, the Commission has reviewed Unison's capital expenditure projections and acknowledges the voluntary commitments made by the company in respect of its planned expenditure.
- 28 The Revised Offer presents Unison's capital expenditure targets over the settlement period, and draws attention to the fact that the targets represent a further increase in expenditure levels over the level of previous years. Forecast capital expenditure is broken down by Unison into four components: customer-driven network extension; network capacity and security augmentation; asset renewals; and underground conversion expenditure.
- 29 In the context of discussing Unison's capital expenditure plans, the Revised Offer states that "Unison's directors have considered the cash flow requirements of the business to ensure that sufficient cash is available to meet the ongoing needs of the business over the settlement period." The Revised Offer and Unison's Asset Management Plan (AMP) both indicate that total capital expenditure over the settlement period is forecast to be 22% higher than was forecast at the time of Unison's Initial Offer in February 2005. The main driver of this increase is forecast renewals expenditure.

- 30 Under its existing price path threshold, Unison undertakes to achieve the targeted level of asset renewals expenditure outlined in its 2006 AMP. Unison does highlight that the company has had problems in meeting its capital expenditure targets in recent years, due to the difficulty in increasing both internal and contractor capability to undertake the necessary level of work. Consequently, in the Revised Offer, Unison commits to reporting in its subsequent annual AMPs on the cumulative renewals spend against the forecast in the settlement proposal.
- 31 Throughout much of the post-breach inquiry into Unison's performance, Parsons Brinckerhoff Associates (PBA) has provided the Commission with relevant specialist engineering and valuation advice. Following Unison's proposal to submit a revised administrative settlement offer, the Commission requested PBA to review Unison's investment proposals, maintenance plans and system reliability. PBA's report (2006 AMP Review) was publicly released with the Draft Decision Paper.
- 32 PBA's 2006 AMP Review generally concludes that Unison's asset management plan is of good quality. However, PBA raises concerns regarding Unison's ability to forecast and deliver its network augmentation needs, and to design and implement network development projects. PBA does accept Unison's underlying conclusion that asset renewal costs must be significantly increased above historical levels.
- 33 Nevertheless, PBA considers that there is scope to reduce the asset renewal budget without significantly impacting the level of supply reliability, and therefore Unison's projections should be considered the upper bound of an acceptable range of asset renewal expenditure. On the other hand, PBA has also reviewed the top-down methodology used by Unison to forecast its network augmentation requirements and considers that it may understate the requirement over the medium to longer term. The Commission notes that, in complying with its existing price path threshold, Unison will still be free to make its own decisions regarding any trade-off that might be warranted between its asset renewal and its network augmentation expenditure (as well as more generally between capital and maintenance expenditure).

#### ***Quality proposals and 2006 asset management plan review***

- 34 At the time the Intention Paper was published, Unison's past breaches of the reliability criteria of the quality threshold had not yet been investigated. In the Revised Offer, Unison contends that the settlement should resolve Unison's past quality breaches on the basis that it has applied and continues to apply sound asset management practices which have been reviewed for the Commission by PBA. However, Unison reiterates its belief that the reliability criteria of its quality threshold have been set too low, as a result of inadequate data quality and completeness stemming from the acquisition of UNL's Rotorua/Taupo assets.
- 35 Nevertheless, Unison acknowledges that the Commission intends retaining the existing quality threshold for the remainder of the settlement period, and reaffirms its commitment to maintaining the level of effort and expenditure directed at maintaining network performance. Unison highlights that the level of planned maintenance expenditure and capital expenditure is planned to increase in order to contribute to improved reliability. Like capital expenditure, Unison's maintenance expenditure forecasts in the 2006 AMP have increased since its 2005 AMP, by about 23% over the settlement period.

- 36 Given that PBA was already examining related aspects of Unison's performance as part of its 2006 AMP Review, the Commission requested PBA to also assess Unison's reliability and service levels, in light of the company's past breaches of the quality threshold and its future plans for relevant capital and maintenance expenditure. In its review, PBA observes that, up until Unison's 2006 AMP, the company had expected maintenance expenditure to stabilise and then decrease over time. PBA considers that the subsequent increase in the forecast is nevertheless appropriate, because ongoing expenditure on network maintenance is needed to improve SAIFI.
- 37 The Commission accepts PBA's key findings and recommendations with respect to Unison's system reliability, which are that:
- no change is warranted to the reliability criteria of Unison's quality threshold, because Unison's reliability is expected to improve over time in response to the increased level of planned expenditure, and holding the criteria at their present levels will place incentives on Unison to ensure that the additional expenditure is efficient and appropriately targeted;
  - no further action from the Commission is currently required in respect of Unison's past breaches of the reliability criteria of the quality threshold, because Unison's current asset management practices in respect of the management of its maintenance and asset renewal budgets are appropriate and are in accordance with good industry practice; and
  - the Commission should monitor the adequacy of Unison's maintenance, asset renewal and network augmentation budgets, and the efficiency and effectiveness with which all three budgets are managed, given that all three areas impact system reliability.

## **Decision Not to Declare Control of Unison**

- 38 In its intention to declare control, the Commission outlined its view at the time that control of Unison's electricity distribution services would be consistent with the objectives of the targeted control regime. Having now evaluated Unison's Revised Offer, and taken into account the views of interested parties, the Commission's view is that control is *not* necessary to address the concerns identified in the Intention Paper (which are summarised above), because these concerns will be appropriately addressed through acceptance and implementation of the Revised Offer.

### ***Limiting excessive profits***

- 39 While control would limit Unison's ability to extract excessive profits, Unison's compliance with its existing price path threshold will, in the Commission's view, achieve the same objective at lower administrative and compliance costs. Furthermore, Unison's incentives to invest to maintain network performance will be preserved over the settlement period, because the company will continue to earn at least a commercial return and the company's directors have specifically considered the cash flow requirements of the business in the context of Unison's capital expenditure projections. In addition, monitoring by the Commission—through reviews of Unison's AMPs—will ensure that Unison is accountable for reporting progress on its actual versus planned investments, and for explaining any variances.

### ***Benefits to consumers from lower average prices***

- 40 The Intention Paper indicated that control would result in lower prices, on average, for Unison's consumers, particularly in Rotorua and Taupo. Since the Commission's intention to declare control was published in September 2005, Unison's Rotorua/Taupo consumers have already received benefits stemming from the Commission's post-breach inquiry, because in April 2006 Unison reversed its most recent price increases to those consumers. Unison's compliance with the price path threshold from 1 December 2006 has resulted in further price reductions for all consumers, on average.
- 41 In the Commission's view, any additional but forgone short-term benefits to Unison's consumers, from potentially lower prices under control, are likely to be more than offset over time by the benefits arising from allowing Unison to retain any additional efficiency gains it makes over the settlement period. This is because doing so preserves Unison's incentives to make ongoing efficiency gains, and increases the level of benefits available to be shared with consumers when the thresholds are reset in 2009. In addition, there are likely to be positive impacts on investment and efficiency incentives for the wider industry from the regulatory stability signals provided by the Commission in reinforcing its commitment to a medium-term price path.

### ***Addressing the disparity in returns between Hawke's Bay and Rotorua/Taupo consumers***

- 42 While the Intention Paper indicated that control could address the disparity in the returns received from Unison's Hawke's Bay consumers and its Rotorua/Taupo consumers, Unison's Revised Offer goes further by addressing similar disparities between customer groups as well. Unison's planned tariff rebalancing programme espouses cost-reflective pricing principles, and will likely provide allocative efficiency benefits in a less intrusive and costly manner than would be the case under control, because when authorising Unison's prices for controlled services the Commission might have no option but to mandate a Cost of Supply model.

### ***System reliability***

- 43 In addition to addressing the concerns raised in the Intention Paper, the Revised Offer explicitly addresses Unison's system reliability performance, which had not been investigated at the time of the Intention Paper. The Commission has now investigated Unison's past breaches of the quality threshold and considers that no further action is necessary at this time. This is because Unison's current asset management practices relating to its maintenance and asset renewal budgets appear to be appropriate and in accordance with good industry practice.

### ***Commission's decision***

- 44 In conclusion therefore, the Commission's considers that the outcomes associated with the administrative settlement proposed in Unison's Revised Offer are consistent with the objectives of the targeted control regime. Furthermore, over the relatively short settlement period from now until the 2009 threshold reset, acceptance and implementation of the settlement will be at least as advantageous to the long-term interests of consumers as would control. Unison's Revised Offer has now been formalised through a Settlement Deed that incorporates the terms of that offer.

- 45 As a result, at this stage, a declaration of control in respect of Unison's electricity distribution services is not necessary to ensure that the objectives of the regime are achieved. Therefore, the Commission has decided not to make a declaration of control in respect of the distribution services supplied by Unison.

# 1 INTRODUCTION

## Purpose and Scope

- 1.1 The Commerce Commission (Commission) has published in the *New Zealand Gazette* (*Gazette*) its intention to make a declaration of control under Part 4A of the Commerce Act 1986 (the Act), in respect of services supplied by Unison Networks Limited (Unison).<sup>2</sup> Unison is a distribution business that supplies electricity distribution services to consumers in the Hawke's Bay, Rotorua and Taupo regions.
- 1.2 Since publishing that intention, and its reasons for forming that intention,<sup>3</sup> the Commission has received an administrative settlement offer from Unison (dated 31 August 2006, as amended on 13 September and 18 October 2006) that includes commitments concerning Unison's performance for the period until 31 March 2009.<sup>4</sup>
- 1.3 The purpose of this paper is to set out the Commission's reasons for deciding not to declare control in respect of Unison's distribution services, and why it has accepted Unison's administrative settlement offer.
- 1.4 Acceptance of Unison's settlement offer—through a Settlement Deed that incorporates the terms of that offer—means that the Commission can close its post-breach inquiry into all of Unison's past threshold breaches prior to 1 April 2006, and can therefore publish its reasons for not making a control declaration in the *Gazette*, in accordance with s57H(d)(ii) of the Act.
- 1.5 Part 4A came into effect on 8 August 2001 and, among other things, requires the Commerce Commission (Commission) to implement a *targeted control regime* for the regulation of large electricity lines businesses (lines businesses)—namely the 28 distribution businesses (one of which is Unison) and the state-owned transmission company, Transpower New Zealand Limited (Transpower).
- 1.6 Under subpart 1 of Part 4A (ss 57D to 57N of the Act), the Commission must set thresholds for the declaration of control of services provided by lines businesses. The thresholds are a screening mechanism for the Commission to identify lines businesses whose performance may warrant further examination, and if necessary, control of their prices, revenues and/or service quality.
- 1.7 The Commission must assess lines businesses against the thresholds it has set, identify any lines business that breaches the thresholds, and determine whether or not to declare control in relation to the services supplied by an identified lines business, taking into account the purpose statement contained in s 57E of the Act (Purpose Statement). In determining whether or not to declare control in relation to any lines

---

<sup>2</sup> *Commerce Act (Intention to Declare Control: Unison Networks Limited) Notice 2005*, *New Zealand Gazette*, Issue No. 156, 9 September 2005, pp 3897-3900.

<sup>3</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Intention to Declare Control, Unison Networks Limited*, 9 September 2005.

<sup>4</sup> Unison Networks, *Settlement Proposal*, 31 August 2006; Unison, *Unison's Settlement Proposal*, Letter from Ken Sutherland to Michael Clark, 13 September 2006; Unison, *Unison's Settlement Proposal*, Letter from Ken Sutherland to Michael Clark, 18 October 2006.

business breaching the thresholds, the Commission may conduct a “post-breach inquiry”.

- 1.8 Unison has breached the thresholds at the first, second, third and fourth assessment dates (i.e., 6 September 2003, 31 March 2004, 31 March 2005 and 31 March 2006 respectively). The Commission’s decision to publish an intention to declare control, pursuant to s 57I of the Act, followed investigations and analysis undertaken by the Commission as part of a post-breach inquiry into aspects of Unison’s breaches, and into Unison’s possible performance and behaviour over the next few years in the absence of control.
- 1.9 Unison’s subsequent administrative settlement offer involves the company voluntarily reducing its average prices from 1 December 2006 to comply with its existing price path threshold for the remainder of the current five-year regulatory period. Unison’s offer also involves rebalancing its line charges to different regions and customer groups, so that the prices paid by consumers reflect the costs of supplying them.
- 1.10 On 9 November 2006, having reviewed Unison’s offer, the Commission issued its draft decision to not make a declaration of control in respect of Unison’s distribution services (Draft Decision Paper),<sup>5</sup> and invited interested parties to give their views on that draft decision.
- 1.11 The Commission has now taken into account the views of interested parties, and has decided not to declare control of Unison’s distribution services. An overview of the Commission’s reasons for not declaring control will be shortly published in the *Gazette* (Decision Notice). In sum, those reasons are that the Commission considers Unison’s performance during the settlement period—if in compliance with the terms of the administrative settlement—would be consistent with the Purpose Statement. Consequently, the objectives of the regime can be achieved without a declaration of control being made, provided the settlement is implemented.
- 1.12 This paper supplements the Decision Notice by presenting the Commission’s detailed reasons for not making a control declaration, and responds to the points raised in submissions and cross-submissions by interested parties. The paper is structured as is shown in the table below.

Section Heading	Content
Introduction	<ul style="list-style-type: none"> <li>▪ Purpose and scope of this paper</li> <li>▪ Statutory framework and process</li> </ul>
Background to Unison’s Settlement Offer	<ul style="list-style-type: none"> <li>▪ Unison Networks Limited</li> <li>▪ Unison’s breaches of the thresholds</li> <li>▪ Evaluation of Unison’s pricing behaviour</li> <li>▪ Post-breach inquiry into Unison’s performance</li> <li>▪ Unison’s initial administrative settlement offer</li> <li>▪ Judicial review proceedings</li> <li>▪ Decision to publish an intention to declare control</li> <li>▪ Unison’s revised administrative settlement offer</li> </ul>

<sup>5</sup>

Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Draft Decision: Reasons for Not Declaring Control, Unison Networks Limited*, 9 November 2006.

Section Heading	Content
Framework for Evaluating Administrative Settlements	<ul style="list-style-type: none"> <li>▪ Statutory interpretation</li> <li>▪ Basis for not declaring control</li> <li>▪ Relevant factual and counterfactual for evaluating settlement offers</li> <li>▪ Net benefits of accepting and implementing a settlement offer</li> <li>▪ Views of interested parties</li> </ul>
Evaluation of Unison's Settlement Offer	<ul style="list-style-type: none"> <li>▪ Overview of Unison's Revised Offer</li> <li>▪ Aggregate pricing proposals</li> <li>▪ Disaggregated pricing proposals</li> <li>▪ Investment proposals</li> <li>▪ Quality proposals</li> <li>▪ Net benefits assessment</li> <li>▪ Views of interested parties</li> </ul>
Decision Not to Declare Control	<ul style="list-style-type: none"> <li>▪ Decision not to declare control of Unison</li> <li>▪ Next steps</li> </ul>

## Statutory Framework and Process

### *Targeted control regime*

- 1.13 The targeted control regime for lines businesses is outlined in subpart 1 of Part 4A of the Act. The purpose statement of the targeted control regime (Purpose Statement), contained in s 57E of the Act, is:

to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers –

- (a) are limited in their ability to extract excessive profits; and
- (b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share the benefits of efficiency gains with consumers, including through lower prices.

- 1.14 The targeted control regime comprises a number of distinct elements as follows:

- *setting thresholds*, in which the Commission must set and publish “thresholds” for lines business performance, following consultation as to possible thresholds with participants in the electricity distribution and transmission markets and with consumers;
- *assessment and identification*, in which the Commission must assess lines businesses against the thresholds it has set, and must identify any lines businesses that breach those thresholds;
- *post-breach inquiry*, in which the Commission must determine whether to declare all or any of the services supplied by all or any of the identified lines businesses to be controlled; and
- *control*, in which the Commission applies the regime under Part V of the Act for authorising the prices, revenues and/or quality of the controlled services supplied by a lines business for which a declaration of control has been made by the Commission.



- 1.15 Control is *targeted* by virtue of the processes set out in subpart 1 of Part 4A. Unlike overseas jurisdictions, none of the lines businesses is to be automatically subject to control of their prices, revenues or service quality. A business may only be controlled by the Commission if it has breached a threshold, and after the Commission has followed the process outlined in s 57I of the Act (paragraph 1.39).

### ***Price path threshold***

- 1.16 After consulting with interested parties on possible thresholds, as is required under s 57G of the Act, the Commission set two thresholds on 6 June 2003: a CPI-X price path threshold and a quality threshold.
- 1.17 The price path threshold is of the form CPI-X, where CPI is the consumer price index, and the ‘X’ factor represents the expected annual reduction in lines business average prices (i.e., line charges) in real terms, net of certain allowable pass-through costs—most notably, transmission charges (in the case of distribution businesses).
- 1.18 For a distribution business, the price path threshold therefore effectively acts only on the distribution component of its line charges, (i.e., “distribution charges” or “distribution prices”) and not the combined price for all lines services, including transmission services. This is because the transmission charges are themselves subject to the distinct price path threshold applicable to Transpower. Consequently, any distribution business whose average distribution price changes at an annual rate exceeding the change in the CPI, less than the annual rate of X percent set by the Commission for that business, will breach the price path threshold. For a typical residential customer, distribution charges can range from 20-40% of the total power bill. Also, the thresholds do not apply to the wholesale or retail components of electricity prices, as these are not subject to regulatory oversight under Part 4A.
- 1.19 The price path threshold is conceptually similar to the various forms of CPI-X price control that regulators in overseas jurisdictions commonly use for regulating utilities. However, the price path threshold is not an instrument of control, but a screening mechanism. Nevertheless, like CPI-X instruments applied in regulatory regimes in other countries, the price path threshold is intended to provide incentives consistent with the underlying statutory objectives. In the case of the thresholds, those objectives are set out in the Purpose Statement contained in s 57E of the Act (paragraph 1.13).
- 1.20 Setting a CPI-X price path recognises that distribution businesses face inflationary and other increasing cost pressures, but it also places incentives on businesses to improve their efficiencies in real terms by X percent each year. However, businesses face even stronger incentives to improve efficiencies, because they get to keep the benefits of efficiencies greater than those implied by their CPI-X price path for a number of years. These efficiency gains are realised by the business in the form of higher profits, but are shared with consumers over the long term through prices lower than would otherwise be the case.

### ***Quality threshold***

- 1.21 The quality threshold has two sets of criteria:
- *reliability criteria*, requiring no material deterioration in reliability, measured in terms of SAIDI and SAIFI, with the current year's reliability performance compared against average SAIDI and SAIFI from 1999-2003;<sup>6</sup> and
  - *consumer engagement (or customer communication) criteria*, requiring meaningful engagement with consumers to determine their demand for service quality.
- 1.22 The Commission has indicated that lines businesses which have breached the reliability criteria of the quality threshold may offer some explanation or background information, explaining, for example, that the breach was attributable to:
- a rare but high impact event (i.e., an "extreme event"), such as a very severe storm;
  - normal variation in the reliability performance measure; or
  - increased frequency and/or duration of planned outages associated with major development or refurbishment of the network.<sup>7</sup>

### ***Initial thresholds***

- 1.23 The thresholds were initially set by a notice in the *Gazette* to apply to distribution businesses from 6 June 2003 until 31 March 2004,<sup>8</sup> and were explained in a decisions paper published on the same day.<sup>9</sup> All distribution businesses were assessed against the initial price path threshold as at 6 September 2003 (first assessment date) and against both the price path and quality thresholds as at 31 March 2004 (second assessment date).
- 1.24 The assessment criteria set in relation to the initial price path threshold were set to be generally consistent with a CPI-X price path, in which distribution prices at the end of each assessment period were not to be greater, in nominal terms, than the distribution prices at the start of that period. Hence, the initial X factor was equivalent to the CPI.

### ***Reset thresholds***

- 1.25 After further consultation with interested parties, the Commission reset the thresholds for distribution businesses from 1 April 2004 for a five-year regulatory period. The *reset thresholds* (also referred to as "revised thresholds") are of the same form as the initial thresholds set by the Commission on 6 June 2003. However, for the price path

---

<sup>6</sup> SAIDI is the system average interruption duration index, which measures the annual average length of time for a power outage, measured in minutes of lost electricity supply per consumer. SAIFI is the system average interruption frequency index, which measures the average number of power outages experienced by a consumer each year.

<sup>7</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Assessment and Inquiry Guidelines*, 19 October 2004, paragraph 167.

<sup>8</sup> Commerce Act (*Electricity Lines Thresholds*) Notice 2003, Supplement to *New Zealand Gazette*, Issue No. 62, 6 June 2003.

<sup>9</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime: Thresholds Decisions*, 6 June 2003.

threshold, new X factors applied, with businesses assigned to four groups (i.e., X = -1%, 0%, 1%, or 2%), based on their relative efficiency and relative profitability.

1.26 Each X factor reflects a combination of:

- expected industry-wide improvements in efficiency (which was found through total factor productivity analysis to be a 1% gain per annum for all businesses);
- the relative performance of each group of businesses compared to that industry-wide average, based on
  - a relative productivity (i.e., efficiency) component (which was determined using multilateral total factor productivity analysis, and set to -1%, 0% or +1% for above-average, average and below-average performance, respectively), and
  - a relative profitability component (which was determined by comparing residual rates of return, and set to -1%, 0% or +1% for below-average, average and above-average profitability, respectively).

1.27 The reset thresholds for distribution businesses were set by a notice in the *Gazette* (Distribution Thresholds Notice),<sup>10</sup> and explained in an accompanying decisions paper.<sup>11</sup> All distribution businesses were required to submit threshold compliance statements reporting their self-assessments against both the reset price path threshold and the quality threshold as at 31 March 2005 (third assessment date) and 31 March 2006 (fourth assessment date).

### ***Incentives provided by the thresholds***

- 1.28 The price path threshold provides strong incentives for distribution businesses to improve efficiency while limiting their ability to extract excessive profits. Although the price path threshold is not intended to share all the benefits of efficiency gains with consumers in the *short term*, consumers will benefit in the *long term* from prices lower than they otherwise would be, and from an appropriate level of service quality.
- 1.29 First, all distribution businesses face an X factor which partly reflects expected industry-wide improvements in efficiency (paragraph 1.26). Therefore, there will be some sharing of efficiency gains with consumers *during* the five-year regulatory period.
- 1.30 Second, and more significantly, businesses have an incentive to outperform the efficiency expectations implied by their price path threshold (paragraph 1.19), thereby increasing the level of benefits that are potentially available to be shared with their consumers from the *end* of the regulatory period, when the thresholds are reset in 2009. These additional benefits arise because, during the regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their CPI-X price path. Furthermore, allowing a distribution

<sup>10</sup> Commerce Act (Electricity Distribution Thresholds) Notice 2004, Supplement to New Zealand Gazette, Issue No. 37, 31 March 2004.

<sup>11</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime: Thresholds Decisions (Regulatory Period Beginning 2004)*, 1 April 2004. Both the Commission's initial and reset price path threshold decisions have been, and are still, subject to legal challenge (paragraphs 2.32-2.37).

business to retain this higher level of returns preserves the incentives for that business to make ongoing efficiency gains in subsequent periods.

- 1.31 Finally, at the end of the regulatory period, the CPI-X price path will be reset in manner intended to share the benefits of the additional efficiency gains made during that past period with consumers over the next regulatory period. (The Commission intends consulting with interested parties on the appropriate level of efficiency gains to be shared with consumers, and the mechanism for sharing such benefits, in the lead up to the 2009 threshold reset).
- 1.32 The quality threshold provides incentives for distribution businesses to not allow their reliability to fall as a means of reducing their costs in response to the price path threshold, and to supply services at a quality that reflects consumer demands.

### ***Assessment and Inquiry Guidelines***

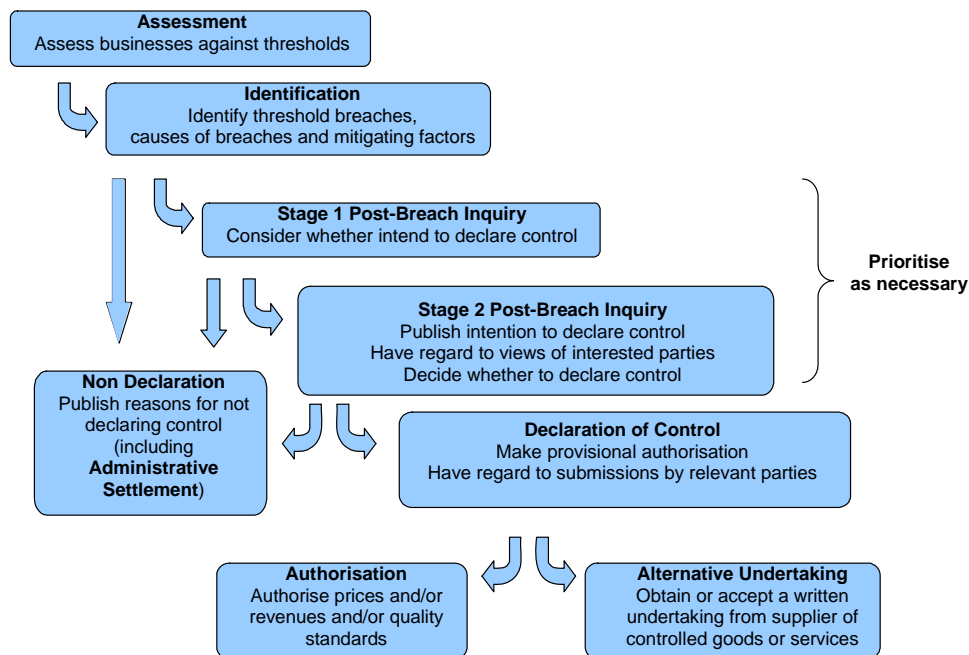
- 1.33 In October 2004 the Commission published its Assessment and Inquiry Guidelines (the Guidelines) which outline the broad process and analytical framework that the Commission intends to use in deciding whether to impose control on a lines business that has breached the thresholds.<sup>12</sup> The Guidelines describe the statutory framework and outline both the statutory and discretionary process steps the Commission proposes following in the assessment, identification and post-breach inquiry elements of the targeted control regime. These processes are illustrated in Figure 1, in which the various statutory and discretionary process steps are grouped and labelled.

### ***Assessment and identification***

- 1.34 Before determining whether to declare control in relation to any lines business, ss 57H(a) and 57H(b) of the Act require that the Commission must:
  - assess large electricity lines businesses against the thresholds set under subpart 1 of Part 4A; and
  - identify any large electricity lines business that breaches the thresholds.
- 1.35 Consequently, each lines business is annually required to provide the Commission with a threshold compliance statement in accordance with the notice in the *Gazette* which specifies the threshold assessment criteria. Each compliance statement must provide a self-assessment, with sufficient supporting evidence, of whether or not the lines business complies with the thresholds that the Commission has set.
- 1.36 Where the Commission has identified a breach, it may request further information from the lines business concerned to identify the cause of the breach, as well as any mitigating factors pertaining to the breach. This additional information may be sufficient for the Commission to determine that taking further action would not be necessary for the long-term interests of consumers. Alternatively, in its assessment the Commission might find information that the business's current performance is not consistent with s 57E of the Act—in particular, the outcomes sought under (a) to (c) of s 57E are not being achieved in a material aspect.

---

<sup>12</sup> Commerce Commission, *supra* n 7.

**Figure 1: Targeted Control Process Steps**

1.37 Under s 57K of the Act, the Commission may prioritise its duties under subpart 1 of Part 4A to investigate a lines business that has breached a threshold. In so prioritising, s 57K(2) provides that the Commission must have regard to the s57E purpose, and may also have regard to any other factors that it considers relevant, including (without limitation) all, any, or none of the following:

- (a) the size of the business;
- (b) the recent performance of the business, including prices charged and the extent of any excess profits;
- (c) the quality of the information provided to the Commission;
- (d) the extent to which businesses have breached the thresholds set by the Commission.

### ***Post-breach inquiries***

1.38 Under s 57H(c) of the Act, the Commission must determine whether or not to declare all or any of the services supplied by all or any of the identified lines businesses to be controlled, taking into account the purpose of subpart 1 of Part 4A. The Commission terms this determination process a “post-breach inquiry”.

1.39 In addition, s 57I(1) states that, before making any declaration of control under s 57F, the Commission must:

- publish its intention to make a declaration and invite interested persons to give their views on the matter;
- give a reasonable opportunity to interested persons to give those views; and
- have regard to those views.

1.40 The Commission therefore has considered it convenient to divide post-breach inquiries into two-stages:

- **Stage 1** comprises investigations and analysis prior to the Commission forming an intention to declare control; and
- **Stage 2** comprises further investigations and analysis subsequent to the Commission publishing its intention to declare control (during which the Commission must invite and consider the views of interested persons).

### ***Control***

- 1.41 Under section 57J of the Act, a declaration of control under subpart 1 of Part 4A means (as with a declaration of control by Order in Council under Part IV of the Act) that a lines business may not supply the controlled services unless an authorisation or an undertaking has come into effect in respect of those services, and the services are supplied in compliance with the authorisation or undertaking.
- 1.42 Section 57M(1) provides that in exercising its powers under sections 70 to 72 concerning services supplied by a large electricity lines business, the Commission must have regard only to the Purpose Statement, and not to the matters stated in section 70A, and sections 70 to 72 apply with necessary modifications.
- 1.43 Section 70 of the Act provides for the Commission to make an authorisation in respect of all or any component of the prices, revenues or quality standards that apply in respect of the supply of controlled services, using whatever approach it considers appropriate (having regard to the Purpose Statement). Section 71 provides for the Commission to make a provisional authorisation pending the making of a final authorisation.
- 1.44 The authorisation process under Part V is, like the declaration of control process under Part 4A, a consultative process. Before making a final authorisation, s 70B(3) requires the Commission to have regard to submissions made to it by the lines business concerned and the consumers of the controlled services. Under s 73, the Commission has the discretion to hold a conference as part of this process and it may allow other interested parties to be involved in the consultation.
- 1.45 Under s 72, the Commission may instead of making an authorisation in respect of controlled services, obtain or accept a written undertaking from the supplier of those services in relation to those services.

### ***Relationship between post-breach inquiries and control***

- 1.46 The fact that there is a further consultative process under Part V has implications for the Commission's process under Part 4A. The Commission's view is that, in deciding whether or not to declare control, it should not pre-determine the form and nature of control. Post-breach inquiries under Part 4A are therefore limited to assessing whether control should be imposed and do not involve determining the specifics of any authorised prices, revenue and/or quality standards following a declaration of control.
- 1.47 However, in order to calculate the likely costs of control—as is required in forming an intention to declare control—the Commission must select a form of control for that purpose, but only to the extent that it is necessary for the Commission to assess whether control would be to the long-term benefit of consumers.

- 1.48 Any hypothetical form of control—and any prices, revenues and/or quality standards considered during the entire declaration of control process—will accordingly be preliminary and will not pre-empt any decision the Commission may be required to make in the future regarding control, should that be necessary under Part V.<sup>13</sup>

### *Administrative settlements*

- 1.49 The Commission has indicated that it may be possible for a breach to be resolved by an “administrative settlement” between the Commission and the business concerned. (The evaluation of such a settlement offer from Unison, in the context of a decision whether to declare control, is the subject of this paper). Because a settlement would involve the business voluntarily reaching an agreement with the Commission on an appropriate course of action, a better outcome may be achievable than would be the case through control. An administrative settlement option is a well-established way of resolving Commission investigations in relation to Parts II and III of the Act and the Fair Trading Act 1986.
- 1.50 Administrative settlements could be agreed during either a Stage 1 or Stage 2 post-breach inquiry process but, in the case of the latter, the Commission has indicated in the Guidelines that it may only be inclined to do so after formally considering the views of interested parties. It should be noted that the Commission would continue with its inquiry to determine whether or not to declare control alongside any negotiations in respect of a proposed administrative settlement.
- 1.51 If the Commission and a lines business agree on an administrative settlement, the Commission would cease its inquiry and publish its reasons for not making a control declaration. Those reasons would refer to the terms and conditions of the administrative settlement.

### *Government Policy Statement (GPS)*

- 1.52 On 7 August 2006, the Government provided the Commission with a statement of its economic policy relating to the incentives of regulated businesses to invest in infrastructure (the GPS). The GPS was passed to the Commission under s 26 of the Act. Section 26 provides:

#### **Commission to have regard to economic policies of Government**

- (1) In the exercise of its powers under ... this Act, the Commission shall have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister.
- (2) The Minister shall cause every statement of economic policy transmitted to the Commission under subsection (1) of this section to be published in the Gazette and laid before Parliament as soon as practicable after so transmitting it.
- (3) For the avoidance of doubt, a statement of economic policy transmitted to the Commission under this section is not a direction for the purposes of Part 3 of the Crown Entities Act 2004.

- 1.53 The meaning of s 26 was considered by the Commission in *Re NZ Kiwifruit Exporters Assn (Inc)/NZ Kiwifruit Coolstorers Assn (Inc)* [(1989) 2 NZBLC (Com) 104,485] and

<sup>13</sup> This relationship between the Commission’s Part 4A and Part V processes is conceptually equivalent to the relationship between Part IV and Part V, as described in: Commerce Commission, *Gas Control Inquiry, Final Report*, 29 November 2004, pp 2.14-2.16.

by the High Court in *NZ Co-op Dairy Co Ltd v Commerce Commission* [[1992] 1 NZLR 601]. In the Kiwifruit case, the Commission stated (at page 104)

"..having regard to the general policy discretion in the Act to promote competition s 26 may be used to advise the Commission of Government policy or policies or to be more specific in relation thereto. It is not to influence or determine the decisions which the Commission must make. Thus, fully preserving the discretions given to the Commission in the Act, the Commission is required only to have regard to such statements in reaching its decisions. The Oxford Dictionary defines the word 'regard' as meaning 'attention, heed and care'."

1.54 In the High Court case in *NZ Co-op Dairy Co* (at p 612 and 613), the Court observed:

"As with any other evidence it is for the tribunal to assess the weight to be given to each item of evidence and in the case of a statement of this kind, which in our view is simply an evidential statement of Government policy - it is certainly not a direction - it remains for the tribunal to assess the weight to be given to it as an expression of official perception of, in this case, the public benefit. We do not think there is any magic in the words 'have regard to'. They mean no more than they say. The tribunal may not ignore the statement. It must be given genuine attention and thought, and such weight as the tribunal considers appropriate. But having done that the tribunal is entitled to conclude it is not of sufficient significance either alone or together with other matters to outweigh other contrary considerations which it must take into account in accordance with its statutory function: *NZ Fishing Industry Association v MAF* [1988] 1 NZLR 544, at p 566, *Ishak v Thowfeek* [1968] 1 WLR 1718 (PC), at p 1725. In the end, however weighty the statement may be as an expression of considered Government policy, it does not have any legislative effect to vary the nature of the duties which the Tribunal must carry out."

1.55 The GPS provides in material part the following:

#### **Incentives of Regulated Businesses to Invest in Infrastructure**

This statement sets out the Government's economic policy on infrastructure investment in the context of businesses that are, or may be, regulated under Parts 4, 4A or sections 70 to 74 of Part 5 of the Commerce Act.

#### **Introduction and Background**

2. ... the Government has adopted the following overarching objective for infrastructure:

To enhance infrastructure's net contribution to economic growth and societal well-being over time, while reducing the incidence and severity of service failures and adverse effects on the environment.

#### **Economic policy objectives**

7. The Government's economic policy objective is that regulated businesses have incentives to invest in replacement, upgraded and new infrastructure and in related businesses for the long term benefit of consumers. The Government considers that this objective will be achieved by:

- a. regulatory stability, transparency and certainty giving businesses the confidence to make long-life investments;
- b. regulated rates of return being commercially realistic and taking full account of the long-term risks to consumers of underinvestment in basic infrastructure; and
- c. regulated businesses being confident they will not be disadvantaged in their regulated businesses if they invest in other infrastructure and services.

8. The Government also considers that it is important that regulatory control ensures that:

- a. the consumers of regulated businesses are not disadvantaged by the investments of regulated businesses in other infrastructure and services;
- b. regulated businesses are held accountable for making investments in that business where those investments have been provided for in regulated revenues and prices; and
- c. regulated businesses provide infrastructure at the quality required by consumers at an efficient price.



- 1.56 The Commission has carefully assessed and considered each statement in the GPS for the purposes of evaluating Unison's administrative settlement offer in conjunction with the considerations it must take into account in accordance with its statutory functions and powers. The Commission considers that it has given proper and genuine attention to the GPS in reaching the decisions outlined in this paper.

## 2 BACKGROUND TO UNISON'S SETTLEMENT OFFER

### Unison Networks Limited

#### *Overview of the company*

- 2.1 Unison, formerly Hawke's Bay Network Limited, owns and operates the electricity distribution networks in the Hawke's Bay, and Rotorua/Taupo regions. The Rotorua and Taupo networks were acquired from UnitedNetworks Limited (UNL) and Vector Limited on 1 November 2002 as part of the contemporaneous sale of a number of networks owned by UNL.<sup>14</sup> Unison acquired the Rotorua and Taupo assets for \$196.2 million, which was \$89.9 million higher (i.e., 84.5% higher) than the value of those assets valued in accordance with New Zealand Financial Reporting Standard 3 (with the difference being recorded by Unison as "goodwill arising on acquisition").
- 2.2 As a result of this acquisition, Unison is now the fourth largest distribution business in New Zealand, measured by regulatory asset value, system length or consumer connections. As at 31 March 2006, Unison had 104,578 consumer connections (59,634 in the Hawke's Bay region; and 44,944 in the Rotorua/Taupo region), 9,317 km of lines and cables, and a supply area covering 11,500 square kilometres.
- 2.3 The company remains 100% owned by the Hawke's Bay Power Consumers' Trust (HBPCT). The HBPCT is an elected body which acts on behalf of the consumer beneficiaries of Unison, namely those consumers connected to Unison's network in the Hawke's Bay region. Consumers in the Rotorua /Taupo region are not beneficiaries of any distributions that might be made to the HBPCT.
- 2.4 In addition to the networks that it owns, since 1 October 2002 Unison has managed the Central Hawke's Bay distribution network owned by Centralines Limited (Centralines) through a management service contract. The Commission's post-breach inquiry described in this paper relates solely to Unison's line business activities and not to Centralines or the associated management service contract.

#### *Initial analysis of Unison*

- 2.5 Under the initial CPI-X price path threshold (paragraphs 1.23-1.24), all distribution businesses were effectively set the same X factor. To comply with the price path threshold, businesses were required to ensure that, at the first and second assessment dates (i.e., 6 September 2003 and 31 March 2004 respectively), average prices were at or below levels in August 2001 (i.e., when Part 4A was enacted).
- 2.6 As part of resetting these initial thresholds, the Commission undertook a relative productivity and profitability analysis of all distribution businesses, allocating businesses to above-average, average and below-average groups for both productivity and profitability (paragraph 1.25). Unison was found to fall in the average productivity group based on its performance from 1 April 1999 to 31 March 2003. The business was also found to fall in the below-average profitability group, based on

---

<sup>14</sup> Unison acquired UNL's Rotorua and Taupo networks. Powerco acquired UNL's Thames Valley and Tauranga networks. Vector retained UNL's North Auckland and Wellington networks.

its performance from 1 April 1999 to 31 March 2002—in other words, prior to the company’s acquisition of the Rotorua and Taupo networks.<sup>15</sup>

- 2.7 As a result, the Commission assigned Unison an overall X factor of 0%, meaning that, from 1 April 2004, Unison would have been able to increase its average prices by the CPI for the next five years without breaching the reset price path threshold, had it not already increased prices in 2002.

## Unison’s Breaches of the Thresholds

### *Price path threshold*

- 2.8 From reviewing Unison’s respective compliance statements, the Commission has identified Unison as having breached the price path threshold at the first, second, third and fourth assessment dates.
- 2.9 Unison breached the price path threshold at the first assessment date by \$1.8 million (or 4.0% of notional revenue),<sup>16</sup> primarily as a result of line charge increases to electricity consumers in the Hawke’s Bay region by around 10% from 1 April 2002.<sup>17</sup> (Price increases for the Rotorua and Taupo regions had also been implemented on the same date by the previous owner of the assets, UNL).<sup>18</sup>
- 2.10 Unison breached the price path threshold at the second assessment date as a result of further price increases on 1 March 2004.<sup>19</sup> Line charges were targeted by Unison to increase by 6% on average for consumers in the Rotorua and Taupo regions, and by 22% on average in the Hawke’s Bay region (corresponding to increases on delivered electricity prices to end consumers of around 2% and 8% respectively).<sup>20</sup> The magnitude of this second breach was \$11.0 million (or 23.9% of notional revenue).
- 2.11 Unison’s compliance statements for the third and fourth assessment dates indicate that Unison breached the price path threshold by \$8.1 million (or 17.3% of notional revenue) in 2005, and by \$5.2 million (or 10.8% of notional revenue) in 2006.<sup>21</sup> As

<sup>15</sup> Given the disclosed information available at the time of resetting the thresholds it was not possible to estimate the UNL revenue for 2002/03 attributable to Unison, Vector and Powerco following their acquisition of various UNL networks. Refer: Commerce Commission, *supra* n 11, p 59; and Meyrick and Associates, *Regulation of Electricity Lines Businesses, Analysis of Lines Business Performance – 1996-2003*, 19 December 2003, p 61.

<sup>16</sup> Notional revenue is the annualised revenue that would result from applying each set of line charges to the same set of “base” quantities, net of pass-through costs (i.e., transmission charges, local authority rates and, from 1 April 2004, Electricity Commission levies). It does not reflect the actual revenue amount of the breach, but provides an approximation to the additional revenue above that permitted by the price path threshold that would be collected by the business if current charges for distribution services were sustained for a full year, in the absence of demand growth.

<sup>17</sup> Unison, *Threshold Compliance Statement for the First Assessment Date*, 17 October 2003.

<sup>18</sup> Prior to the increases on 1 March 2004, prices in the Hawke’s Bay network changed three times since 1993: an increase in 1996; a decrease and restructure on 1 July 2001; and the increase in 2002.

<sup>19</sup> Unison, *Threshold Compliance Statement for the Second Assessment Date, 31 March 2004*, 20 May 2004.

<sup>20</sup> Unison, *Pricing Review 2004, Pricing Impact Analysis*, Prepared for Board of Directors, December 2003, pp 1, 4 and 5.

<sup>21</sup> Unison, *Threshold Compliance Statement for the Assessment Period Ending on 31 March 2005*, 20 May 2005; Unison, *Threshold Compliance Statement for the Assessment Period Ending 31 March 2006*, 23 May 2006.

with the breach at the second assessment date, these more recent breaches reflect the price increases implemented on 1 March 2004, rather than any subsequent actions by Unison.

### ***Quality threshold***

2.12 Unison's SAIDI criterion of the quality threshold was set to 152.7 and its SAIFI criterion was set to 2.39, based on the average of these statistics disclosed by Unison for the period from 1 April 1998 to 31 March 2003. The Commission has identified Unison as having breached

- the SAIDI criterion of the quality threshold by 32% at the second assessment date;
- both the SAIDI criterion (by 2%) and the SAIFI criterion (by 34%) at the third assessment date; and
- the SAIFI criterion (by 18%) at the fourth assessment date.

### ***Information initially provided by Unison***

2.13 With its first compliance statement, Unison provided the Commission with a supporting paper to explain the breach. In that paper, Unison argued it was not earning excessive profits, but that its current prices were not sustainable in the medium to long term if Unison were to operate its distribution network for the long-term benefit of consumers.

2.14 In Unison's view, the 2002 price increases were the first step toward achieving an economically efficient level of return over time. As such, Unison claimed its behaviour was consistent with the Purpose Statement. Unison also pointed to significant reductions in operating costs and improvements in reliability achieved in its Hawke's Bay network from 1998 to 2003.<sup>22</sup> Unison had presented similar arguments during the consultation process on resetting the price path threshold.

2.15 In order to determine whether or not to make a declaration of control, the Commission requested Unison to explain:

- the extent to which, and the grounds upon which, Unison considered its recent and current price to be sub-optimal for long-term sustainability and economic efficiency;
- the likely consequences for Unison if it had complied with the Commission's price path threshold as at the first and second assessment dates;
- the likely consequences if Unison were to comply with the Commission's five-year price path threshold from 1 April 2004;<sup>23</sup> and
- the five-year price path that Unison would propose to adopt in the absence of the Commission's price path threshold, and the reasons for that path.

<sup>22</sup> Unison, *Threshold Compliance Statement, Supporting Paper, For the First Assessment Date, 6 September 2003, Prepared for the Commerce Commission*, October 2003, pp ii, 1 and 11.

<sup>23</sup> At the time of the request, the Commission's 23 December 2003 decisions paper already outlined the price path threshold to apply to Unison for the five-year regulatory period from 1 April 2004.

- 2.16 In addition, the Commission required Unison to provide information in support of its explanation, including Board documents, as well as similar material provided by Unison to the HBPCT. The Commission also requested all documentation supplied by Unison to its Board and to the HBPCT in relation to Unison's decision to increase prices in all its network areas on 1 March 2004.

## **Evaluation of Unison's Pricing Behaviour**

### ***Past pricing behaviour***

- 2.17 In providing this material to the Commission, Unison stated that the HBPCT fully supported the 1 March 2004 price increases. The company also argued that the threshold regime introduced by the Commission would work most effectively if the "starting prices" of the price path threshold were closely aligned to "efficient costs", or at least if prices were subject to a glide path towards efficient levels. Unison considered that it was disadvantaged by the use of a starting price for the threshold based on August 2001 price levels.
- 2.18 In considering this past pricing behaviour of Unison, the Commission noted that although Unison—as Hawke's Bay Network—had reduced average line charges by around 10% in July 2001, this reduction was primarily implemented to pass on reductions in transmission charges. The 10% increase in line charges in April 2002 could only be considered a true reversal of the previous price decrease if increases in transmission charges were the reason for the increase, rather than an increase in the distribution component of the price, which is what the price path threshold acts on.
- 2.19 The Commission also noted that the line charges in Unison's Rotorua and Taupo networks had been carried over from UNL's previous tariff schedule for those networks, prior to Unison's acquisition of those networks. Up until the March 2004 price increases, the Rotorua and Taupo regions contributed around 50% of Unison's revenue, with those regions making up around 40% of total consumers. Material provided by Unison acknowledged that the Rotorua and Taupo regions had previously had tariffs set at "commercial levels" (because UNL was a listed company in which consumers were not the beneficial owners). Price increases in those regions were explained as reflecting recent investments made to improve security and quality of supply.<sup>24</sup>
- 2.20 During its reset of the thresholds, the Commission's relative profitability analysis of the distribution businesses had found UNL to be the second most profitable business, with a three-year residual rate of return to 31 March 2002 of 12.2%. While it was not clear to the Commission at that stage of its assessment whether UNL's Rotorua and Taupo networks generated returns above or below this average, the information available to the Commission suggested that the returns being earned warranted closer investigation.
- 2.21 The Commission also concluded that Unison was not necessarily "disadvantaged" as it had claimed by having a starting price for the price path threshold based on August 2001 levels (paragraph 2.17), given that:

---

<sup>24</sup> Unison, *Pricing Strategic Plan*, 11 September 2003, pp 7 and 23.

- the threshold acts on average prices net of transmission charges; and
- the threshold starting price was based on the prior UNL tariff schedule which continued to be applicable in Unison's Rotorua and Taupo networks after November 2002, and not just the Hawke's Bay Network's tariff schedule for Unison's Hawke's Bay consumers.

2.22 The Commission's subsequent analysis of Unison's average prices and returns for the 2003/04 financial year supported this conclusion. However, the main impact of the March 2004 price increases was not realised until the 2004/05 financial year.<sup>25</sup>

### ***Planned pricing behaviour***

2.23 The material provided by Unison also indicated that Unison's Statement of Corporate Intent for 2004/05 was to reflect a post-tax nominal weighted average cost of capital (WACC) target of 9.42%, to be achieved within a few years. It suggested that Unison planned to reach this target over a five-year period, and that this would require revenue increases of 11.3%, 9.1%, 6.8%, 4.5% and 2.3% respectively in each of those years.<sup>26</sup>

2.24 A rate of return target of 9.42% was well in excess of the Commission's indicative range for the WACC.<sup>27</sup> Moreover, in making its revenue projections to reach this target, Unison did not deduct revaluation gains from targeted line charge revenue, as is required where revenue is derived by applying a nominal WACC to a revalued asset value (refer Table 1). Ignoring the effect of revaluation gains substantially understates the effective income which the business earns and, conversely, overstates the allowable revenue from regulated activities.

### **Post-Breach Inquiry into Unison's Performance**

2.25 As a result of this evaluation of Unison's past and planned pricing behaviour, and the information available to the Commission at that stage, it was not evident that taking no further action would be consistent with the long-term interests of consumers. Consequently, the Commission decided to initiate a Stage 1 post-breach inquiry into Unison's performance.

2.26 The Commission therefore sought a significant amount of additional information from Unison through a number of notices issued pursuant to s 98 of the Act. Part of the information sought from Unison was disaggregated data relating to each of the company's networks, given that the beneficiaries of the HBPCT are solely Unison's Hawke's Bay consumers, and not those connected to the Rotorua and Taupo networks.

2.27 Responses from Unison were received over the period September 2004 to January 2005, and included, among other things:

- historical and forecast information relating to the financial and technical performance of Unison's monopoly lines business activities, including revenue,

<sup>25</sup> Commerce Commission, supra n 3, paragraphs 201-218.

<sup>26</sup> Unison, *Revenue Requirement Calculation for Unison*, 17 November 2003.

<sup>27</sup> Commerce Commission, supra n 12, August 2003, pp 38-39.

capital contributions, asset valuations, capital expenditure, direct and indirect costs, tax expenditure, depreciation, interest expenditure and system statistics;

- associated business policies;
- disaggregated information relating to the Hawke's Bay, Rotorua and Taupo networks;
- background information relating to Unison's acquisition of UNL's Rotorua and Taupo assets (including due diligence material); and
- customer surveys relating to network undergrounding.

### **Unison's Initial Administrative Settlement Offer**

- 2.28 In early December 2004, the Commission wrote to Unison stating that, on the basis of the information currently available, and having taken into account the Purpose Statement, the Commission had formed the preliminary view that there were sufficient grounds to proceed to an intention to declare control. At the same time, the Commission requested some more information from Unison, and provided the company with a further opportunity to provide additional information relevant to the Commission's decision whether to publish an intention to declare control.
- 2.29 In response, Unison informed the Commission that it intended making an administrative settlement offer to the Commission by the end of February 2005 (paragraphs 1.49-1.51). Unison also advised that it intended suspending its planned price increases (scheduled for 1 April 2005), pending the outcome of the Commission's investigations.
- 2.30 The Commission decided to defer its decision on whether to publish an intention to declare control until the Commission had had an opportunity to evaluate the impact of Unison's settlement offer. The Commission received the offer from Unison on 1 March 2005.
- 2.31 Unison's administrative settlement offer (Initial Offer) contained, among other things:
- a proposed future price path based on a starting price using Unison's actual March 2004 line charges, a post-tax nominal WACC of 8.4%—although, as with the earlier projections Unison had provided (paragraph 2.24), revaluation gains were not deducted in determining future line charge revenue—and price increases over the remaining regulatory period limited to the CPI;
  - an associated assessment of the financial performance of the Hawke's Bay, Rotorua and Taupo networks over the same period; and
  - a price path based on Unison's interpretation of the Commission's assessment framework outlined in the Guidelines.

### **Judicial Review Proceedings**

- 2.32 Earlier, in May 2004, Unison had filed an application in the High Court for a review of the Commission's decisions concerning the initial and reset price path thresholds and its approach to post-breach inquiries. In early July 2005, Unison sought interim orders from the High Court in Wellington to prevent the Commission from making a decision

whether to publish an intention to declare control, pending the outcome of Unison's application for a judicial review of the Commission's threshold decisions. The High Court dismissed Unison's application for these interim orders.<sup>28</sup> Unison appealed the High Court judgment, which the Court of Appeal subsequently upheld.<sup>29</sup>

- 2.33 The substantive proceedings were heard by the High Court in October 2005, and the judgment was issued on 28 November 2005.<sup>30</sup> The High Court dismissed Unison's challenges to the Commission's thresholds as well as to the Commission's approach for inquiring into Unison's threshold breaches and for deciding whether to publish an intention to declare control.
- 2.34 Unison subsequently appealed the High Court's findings in respect of the legality of the price path thresholds (but not in respect of the post-breach inquiry process). The Court of Appeal hearing was held in July 2006, and the Court dismissed Unison's appeal in December 2006.<sup>31</sup>
- 2.35 The Court of Appeal found the Commission's initial price path threshold did not meet the statutory purpose because it did not adequately screen for those businesses who are candidates for control. The Court found that the reset price path threshold applicable from 1 April 2004 is lawful and promotes the statutory objectives. (The legality of the initial and reset quality thresholds were not at issue in the proceedings).
- 2.36 In its discretion, however, the Court declined to set the initial price path threshold aside. Essentially, the Court of Appeal accepted the Commission's submissions that to set aside the regime would cause considerable disruption to the industry and to consumers. The Court concluded that "the reality is that the revised thresholds are lawful and there is a public interest in their continued operation".<sup>32</sup> The Court did not view any linkage of the revised price path threshold to the initial price path threshold to be fatal as to the lawfulness of the revised threshold.<sup>33</sup> The effect of the Court's decision is that the threshold regime remains fully legally effective and enforceable. Accordingly, despite the Court of Appeal's decision that the initial price path threshold is not consistent with the statutory purpose, the Commission still has the power to inquire under s 57H in relation to a business that has breached the initial price path threshold. In Unison's case, the company also breached the initial and revised quality thresholds as well as the revised price path threshold.
- 2.37 Unison subsequently applied for the Court of Appeal judgment to be recalled by that Court, and also applied for leave to appeal to the Supreme Court. The Court of Appeal has since dismissed Unison's recall application<sup>34</sup> and the Supreme Court has granted Unison leave to appeal.

---

<sup>28</sup> *Unison Networks Limited v The Commerce Commission*, unreported judgment of MacKenzie J, CIV-2004-485-960, 29 July 2005.

<sup>29</sup> *Unison Networks Limited v The Commerce Commission and Anor*, Court of Appeal, CA161/05, 24 August 2005.

<sup>30</sup> *Unison Networks Limited v The Commerce Commission & Powerco Limited*, unreported judgment of Justice Wild, CIV 2004 485 960, 28 November 2005.

<sup>31</sup> *Unison Networks Limited v The Commission*, unreported judgment, CA284/05, 19 December 2006.

<sup>32</sup> *ibid*, para 87.

<sup>33</sup> *ibid*, para 65.

<sup>34</sup> *Unison Networks Limited v The Commission*, unreported judgment, CA284/05, [2007] NZCA 49, 7 March 2007.



## Decision to Publish an Intention to Declare Control

### *Intention to declare control*

- 2.38 As a result of the August 2005 Court of Appeal judgment on the interim orders, the Commission proceeded with deciding whether to publish an intention to declare control on Unison. Having reviewed the administrative settlement offer and the earlier information provided by Unison, the Commission decided to publish an intention to declare control, and this was gazetted on 9 September 2005.<sup>35</sup>
- 2.39 The Commission also published a paper setting out its reasons for forming an intention to declare control, based on its preliminary conclusions concerning Unison's recent and planned performance and behaviour (the Intention Paper).<sup>36</sup> In addition, the Commission released a paper prepared for it by Dr Martin Lally on calculating the weighted average cost of capital (WACC) for electricity lines businesses (the WACC Paper).<sup>37</sup> Interested persons were invited to give their views on the Commission's intention to declare control, as is required under s 57I(1)(a) of the Act.
- 2.40 Shortly after issuing the Intention Paper and the WACC Paper, the Commission released the two Excel spreadsheet models it had used to undertake the excess returns analysis of Unison's planned performance, both on an aggregate whole-of-business basis and on a disaggregated network basis (i.e., for each of the Hawke's Bay, Rotorua and Taupo networks).

### *Commission's analytical framework*

- 2.41 Section 57H(c) of the Act requires the Commission to take into account the Purpose Statement in deciding whether to declare control of a business that has breached one or more thresholds. Once a declaration of control has been made, the Commission must apply the regime under Part V of the Act for authorising the prices, revenues and/or quality standards of the controlled services supplied by a lines business subject to control (or for accepting an undertaking).
- 2.42 Drawing on the Commission's Guidelines (paragraph 1.33), the Intention Paper indicated that the Commission will form an intention to declare control if it is satisfied that, on the basis of available evidence and analysis, the forward-looking long-term benefits of control to consumers would exceed the costs (i.e., the "net benefits to consumers test"). The Intention Paper explained that control is generally intended to realign prices to more efficient levels.<sup>38</sup> Over time, such prices will:
- allow for "normal" returns to be earned, calculated from an appropriate asset base and risk-adjusted rate of return, and covering only efficient operating costs;
  - encourage dynamic efficiency, by sending appropriate signals for investment;
  - aim for allocatively efficient price levels, commensurate with the level of service quality consumers demand and based on productively/dynamically efficient costs; and

<sup>35</sup> Commerce Commission, supra n 2.

<sup>36</sup> Commerce Commission, supra n 3.

<sup>37</sup> Lally, M., *The Weighted Average Cost of Capital for Electricity Lines Businesses*, 8 September 2005.

<sup>38</sup> Commerce Commission, supra n 3, paragraphs 77-83.

- result in efficiency gains being shared with consumers.<sup>39</sup>
- 2.43 The potential net benefits of control to consumers over time are the benefits of control, less the direct and indirect costs of control. Potential benefits may arise from:
- “transfers” to consumers, resulting from any excessive profits reduced by control;
  - the tax effect associated with reducing excessive profits; and
  - net gains in allocative, productive or dynamic efficiency.<sup>40</sup>
- 2.44 The direct costs of control include the compliance costs of the regulated lines business and other market participants involved in the regulatory process, plus the incremental administrative costs of the Commission. The indirect costs of control, which may arise if control were to lead to some forms of inefficient behaviour, were described as being more difficult to quantify.<sup>41</sup>
- 2.45 Determining the benefits of control to consumers involves comparing the prices (and/or quality) of services that would apply in the absence of control (the “*counterfactual*”) with those that might apply if control realigned prices to more efficient levels (the “*factual*”). Revenue in the counterfactual, over and above that allowed in the factual, is considered to be “excess revenue”.<sup>42</sup>

#### ***Commission’s analytical approach***

- 2.46 There are two broad approaches the Commission may consider in determining efficient price levels under the factual: benchmarking, whereby lines business prices are compared against those of comparable services provided by other lines businesses; and building blocks analysis.<sup>43</sup>
- 2.47 The Intention Paper presented the building blocks analysis that was used to estimate Unison’s controlled revenue under the factual over the next five years. The approach “builds” the factual revenue allowed to be earned from regulated distribution services by combining the following building blocks:
- the *return on capital*, comprising the *post-tax nominal WACC* multiplied by the value of the *regulatory asset base* used to provide lines services, where system fixed assets are valued applying the ODV methodology;
  - the *return of capital*, namely the *depreciation* of the regulatory asset base;
  - *operating costs*;
  - the *regulatory tax allowance*, comprising tax payable (after adjusting for any tax losses than can be utilised in the regulated business, or in the wider tax group) plus the interest tax shield (i.e., the tax deduction for interest on debt), which is a necessary adjustment required for consistency with the use of a post-tax WACC that includes an interest tax deduction term;

---

<sup>39</sup> *ibid*, paragraphs 95-97.

<sup>40</sup> *ibid*, paragraphs 101-103.

<sup>41</sup> *ibid*, paragraphs 111-112.

<sup>42</sup> *ibid*, paragraphs 91-94.

<sup>43</sup> *ibid*, paragraphs 116-117.

- *less the revaluation gains*, which is a necessary adjustment required to be consistent with applying a nominal WACC to an indexed regulatory asset base.<sup>44</sup>

2.48 If there were no excess returns, then the actual revenue from regulated activities in the counterfactual would equal allowable revenue from regulated activities in the factual, as shown in Table 1.

**Table 1: Comparison of the Factual with the Counterfactual (Intention Paper)**

Factual		Counterfactual	
	Regulatory Asset Base × WACC <sup>†</sup>		Line Charge Revenue
+	Depreciation of Regulatory Asset Base	+	Capital Contributions (cash & gifted assets)
+	Operating Costs		
+	Regulatory Tax Allowance	+	Other Revenue from Regulated Activities
-	Revaluation Gains <sup>†</sup>		
=	Allowable Revenue from Regulated Activities	=	Actual Revenue from Regulated Activities

<sup>†</sup> The use of a nominal WACC with an indexed asset base requires revaluation gains associated with the indexation to be netted out of the allowable revenue from regulated activities.

### *Commission's net benefits analysis*

2.49 The Intention Paper presented the Commission's assessment of Unison's excess revenues from 2006-2010 on the basis of two different scenarios. These scenarios reflected information available about Unison's planned performance at two different times—both before (Scenario 1) and after (Scenario 2) Unison's increased exposure to the threat of control, as a result of the Commission signalling its preliminary views to Unison in December 2004 (paragraph 2.28).

- *Scenario 1.* The counterfactual revenue for Scenario 1 was based on data that supported Unison's 2004 Statement of Corporate Intent (SCI), which targeted a rate of return of 9.42% by the end of the analysis period (paragraph 2.23). The Commission constructed a corresponding factual revenue path using Unison's own forecasts of capital and operating expenditure applicable to the counterfactual, and by using a rate of return of 7.35% in each year of the analysis period (consistent with the Commission's point estimate in the WACC distribution at the time).
- *Scenario 2.* The counterfactual revenue for Scenario 2 was the revenue path presented in Unison's Initial Offer of February 2005 (paragraph 2.31). This revenue path was lower than the Scenario 1 counterfactual revenue path as a result of Unison's reduced return targets and lower forecasts of revenue from capital contributions. While capital expenditure forecasts were the same in Scenarios 1 and 2, Unison's operating expenditure forecasts in the 2005 Initial Offer were about 18% higher than those applicable at the time of Unison's 2004 SCI (and used in Scenario 1). The Commission constructed a corresponding factual revenue based on this higher level of forecast operating expenditure. As

<sup>44</sup> *ibid*, paragraphs 118-122.

a result, the factual revenue path for Scenario 2 was higher than that for Scenario 1, despite the counterfactual revenue path being lower.<sup>45</sup>

- 2.50 The conclusion presented in the Intention Paper was that Unison would earn significant excess returns under either Scenario 1 or Scenario 2 across a WACC range of 6.45%-8.45% (around a point estimate of 7.35%).<sup>46</sup> Consequently, after taking into account the costs of control—there would be significant net benefits to Unison’s consumers as a result of imposing control. (The Commission estimated annual direct costs of control at \$614,000, but did not quantify indirect costs of control). In addition, the Intention Paper presented the Commission’s analysis of disaggregated excess returns for each of Unison’s Rotorua, Taupo and Hawke’s Bay networks.
- 2.51 On the basis of the analysis presented in the Intention Paper, the Commission concluded that control of the distribution services supplied by Unison would be consistent with the Purpose Statement. In particular, the evidence before the Commission was that:
- Unison had been and was continuing to extract excessive profits from consumers;<sup>47</sup>
  - in the absence of price control, Unison would continue to earn excessive profits in future, whereas control would limit Unison’s ability to extract excessive profits going forward;<sup>48</sup>
  - Unison had been and was continuing to earn significantly higher returns from consumers that were not beneficiaries of the Hawke’s Bay Power Consumers’ Trust (HBPCT) than those received from Unison’s consumers that were beneficiaries of the HBPCT;<sup>49</sup>
  - in the absence of price control, Unison would continue to earn significantly higher returns from consumers that are not beneficiaries of the HBPCT than the returns that would be earned from Unison’s consumer beneficiaries;<sup>50</sup>
  - there would be long-term benefits to consumers following the imposition of control, primarily resulting from prices lower than they would be without control;<sup>51</sup> and
  - benefits of control would likely accrue more to Unison’s Rotorua and Taupo consumers, but would nevertheless also be favourable to Hawke’s Bay consumers.<sup>52</sup>

### *Consultation process on the Intention Paper*

- 2.52 Submissions on the Intention Paper were received during October 2005. A conference was held at the Commission’s offices on 17-18 November and on 5-6 December 2005 to allow the Commission to test the submissions made by interested parties. In

---

<sup>45</sup> ibid, paragraphs 224-240.

<sup>46</sup> ibid, paragraph 257.

<sup>47</sup> ibid, paragraphs 200-218.

<sup>48</sup> ibid, paragraphs 234-245.

<sup>49</sup> ibid, paragraphs 219-223.

<sup>50</sup> ibid, paragraphs 260-270.

<sup>51</sup> ibid, paragraphs 246-259.

<sup>52</sup> ibid, paragraph 271.

addition, given the level of interest from interested persons in the regions supplied by Unison, the Commission decided to hold some sessions of the conference in Hawke's Bay, Rotorua and Taupo. These regional sessions were held on 14 December 2005 in Taupo and Rotorua, and on 15 December 2005 in Napier.

- 2.53 The Commission received 32 submissions on the Intention Paper from the following groups of interested parties:
- submissions from Unison itself and its owner, the Hawke's Bay Power Consumers' Trust (HBPCT);
  - submissions from interested parties in the Hawke's Bay, Rotorua and Taupo regions supplied by Unison; and
  - other submitters, primarily other industry players, that were more particularly interested in the framework and methodological issues associated with the building blocks analysis outlined in the Intention Paper, than the specific impacts on Unison or its consumers.
- 2.54 Following the conference, thirteen cross-submissions were received. Public versions of all submissions, cross-submissions and transcripts can be obtained from the Commission's website: [www.comcom.govt.nz](http://www.comcom.govt.nz). In the decision set out in this paper, the Commission has taken into account these submissions and cross-submissions to the extent that they are relevant to considering whether to accept Unison's most recent administrative settlement offer (which is discussed in the next sub-section) and therefore whether to declare control.

### **Unison's Revised Administrative Settlement Offer**

- 2.55 On 1 April 2006, Unison reversed its March 2004 distribution price rises in Rotorua and Taupo (paragraph 2.10). Unison's move was an interim measure that resulted in the Commission delaying its decision on whether to place the company's distribution services under control. That delay gave Unison time to prepare a revised administrative settlement offer for consideration by the Commission.<sup>53</sup>

#### ***Revised settlement offer of September 2006***

- 2.56 An initial revised administrative settlement offer was received from Unison on 8 June 2006. The Commission reviewed the offer and informed Unison that it was not acceptable in its present form, as in the Commission's view it would result in outcomes not consistent with the Purpose Statement. In addition, the Commission requested that Unison explain to what extent there would be any detriment to consumers as a result of the company complying with its existing price path threshold until the thresholds are reset in 2009—a question that had been posed to Unison at the outset of the investigation process (paragraph 2.15).
- 2.57 Following subsequent discussions between the Commission and Unison, on 1 September 2006,<sup>54</sup> Unison provided the Commission with its final revised administrative settlement offer (dated 31 August 2006), for a settlement period ending

<sup>53</sup> Commerce Commission, *Unison to reverse electricity price rises for Rotorua, Taupo*, Media Release, 17 March 2006.

<sup>54</sup> Unison, *Unison's Settlement Proposal*, Letter from Brian Martin to Paula Rebstock, 1 September 2006.

on 31 March 2009.<sup>55</sup> The offer outlined Unison's commitment to voluntarily implementing tariff changes from 1 October 2006 to a level that would result in compliance with its existing price path threshold (paragraph 2.7) as at 31 March 2007, had those tariffs been applied from 1 April 2006. Subsequent tariff reviews at 1 April 2007 and 1 April 2008 would likewise be undertaken to maintain compliance with the existing price path threshold.

- 2.58 In addition, Unison's offer indicated that, on a regional basis, the tariff changes over the settlement period would reflect cost allocations between the regions that result in a consistent rate of return from each regional network. Furthermore, Unison would rebalance tariffs between customer groups to better deliver cost reflective prices, in accordance with the allocation of costs in Unison's new Cost of Supply model.
- 2.59 On 13 September 2006, Unison wrote to the Commission indicating that it needed to amend the offer with respect to the 1 October target date for its voluntary tariff changes.<sup>56</sup> Unison explained that retailers had confirmed they understood the circumstances in which Unison was proposing a tariff change beyond the normal annual cycle and therefore Unison would still be able to change tariffs again as at 1 April 2007. However, retailers universally resisted the 1 October tariff change date, because—due to the rebalancing—the change would have involved a mix of individual tariff increases and decreases. Instead, the earliest date that the retailers could agree on to implement the change was 1 December 2006.
- 2.60 Subsequently, on 18 October 2006, Unison updated the Commission on its progress in gaining acceptance from retailers on implementing the tariff changes from 1 December.<sup>57</sup> Given resistance from some retailers to a 1 December date, Unison proposed implementing the rebalancing for a number of Rotorua/Taupo customer classes in two stages, with the second stage being on 1 April 2007. (Unison's 31 August document, as amended by its letters of 13 September and 18 October 2006, is subsequently termed the Revised Offer).

### ***Commission's Draft Decision Paper***

- 2.61 The Commission reviewed Unison's Revised Offer and formed the preliminary view that, in complying with the terms of the administrative settlement, Unison's performance during the settlement period would be consistent with the Purpose Statement. Consequently, the objectives of the regime could be achieved without a declaration of control needing to be made, provided that the settlement would be implemented. Moreover, in the Commission's view, the Revised Offer formed a suitable basis for consultation with interested parties.
- 2.62 On 9 November 2006, the Commission issued its Draft Decision Paper to not make a declaration of control in respect of Unison's distribution services (paragraph 1.10), and invited interested parties to give their views on that draft decision and on Unison's Revised Offer (which was publicly released along with the Draft Decision Paper).

---

<sup>55</sup> Unison, supra n 4, 31 August 2006.

<sup>56</sup> Unison, supra n 4, 13 September 2006.

<sup>57</sup> Unison, supra n 4, 18 October 2006.

- 2.63 Submissions were due on 29 November 2006 and were received from six interested parties: Orion, Powerco, Vector, Mighty River Power (MRP), the Major Electricity Users' Group (MEUG) and the Consumer Coalition on Energy (CC93).<sup>58</sup> Cross-submissions were due on 11 December 2006 and were received from MEUG, CC93 and Unison.<sup>59</sup>

***Commission's final decision***

- 2.64 The Commission has now taken into account the views of interested parties, and has decided not to declare control of Unison's distribution services. The following sections of this paper outline the Commission's framework for evaluating Unison's administrative settlement offer, summarise the Commission's specific review of Unison's Revised Offer, respond to the points raised in submissions and cross-submissions by interested parties on the Draft Decision Paper and the Revised Offer, and provide the Commission's reasons as to why no declaration of control in respect of the electricity distribution services supplied by Unison needs to be made at the present time.

---

<sup>58</sup> Orion, *Submission on Draft Decision: Reasons for Not Declaring Control Unison Networks Limited*, 29 November 2006; Powerco, Letter from Caroline Ramsey to Unison Post-Breach Inquiry Team, 29 November 2006; Vector, *Submission on Reasons for Not Declaring Control of Unison*, 29 November 2006; Mighty River Power, *Submission to the Commerce Commission on Draft Decision: Reasons for Not Declaring Control – Unison Networks Limited*, 29 November 2006; MEUG, *Submission on Unison's Draft Settlement Proposal*, 29 November 2006; CC93, *CC93 Recommend an Amended Settlement Counter-Offer to Unison*, 29 November 2006.

<sup>59</sup> MEUG, *Cross-submission on Unison's draft settlement proposal*, 11 December 2006; CC93, *Cross-submission on Unison's draft settlement*, 11 December 2006; Unison, *Cross-submission by Unison Networks Limited*, 11 December 2006.

### 3 FRAMEWORK FOR EVALUATING ADMINISTRATIVE SETTLEMENTS

- 3.1 This section sets out the analytical framework that the Commission has used for evaluating Unison's most recent administrative settlement offer—the Revised Offer, and summarises the views of interested parties on that framework. This framework forms the basis for the Commission's decision that it ought to accept Unison's Revised Offer and decide not to declare control.

#### Statutory Interpretation

##### *Purpose statement of the targeted control regime*

- 3.2 As described above (paragraph 2.41), in determining whether or not to declare control, the Commission must have regard to the overall purpose of the targeted control regime, which is contained in s 57E.

- 3.3 Section 57E sets out the purpose of subpart 1 of Part 4A and how that purpose is to be achieved in the following terms:

...to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers –

- (a) are limited in their ability to extract excessive profits; and
- (b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share the benefits of efficiency gains with consumers, including through lower prices.

- 3.4 In *Unison Networks Limited v the Commission & Powerco Limited* (described above in paragraphs 2.32-2.33), the High Court held at paragraphs [110] to [112] that for the purpose of construction, the Purpose Statement in s 57E of the Act may be broken into three parts on the following basis:

First there is the statement of purpose: .... to promote the efficient operation of markets directly related to electricity distribution ... services ...

Second, is the means of achieving that purpose: ... through targeted control for the long term benefit of consumers.

Third, is the amplification of that means, in the form of ensuring that the objectives set out in paragraphs (a) to (c) are achieved.<sup>60</sup>

- 3.5 The High Court observed at paragraph [59] that s 57E(a) to (c) “are identified by Parliament as central aspects of the long-term interests of consumers and are central, though not exclusive, goals for the Commission in the performance of its duties under subpart 1 of Part 4A”.

- 3.6 The High Court held that the s 57E(a) to (c) goals have the following meanings:

- (a) As to (a), the goal is to ensure that LELBs [i.e., large electricity lines businesses] are limited in their ability to earn profits in excess of their WACC. Differently put, the aim is to limit the ability of LELBs to earn greater than normal profits.

---

<sup>60</sup> supra n 30.



- (b) The s57E(b) aim requires the Commission to direct its actions toward the goals of ensuring that LELBs do not incur unnecessary or wasteful costs, and make appropriate trade-offs between increased quality and cost. Expenditure should be restricted to meeting quality standards required by consumers.
- (c) Section 57E(c) requires the Commission to ensure that efficiency gains when achieved, are shared with customers. Implicit in "sharing" is that the LELB can retain some of the gain. The sharing could take the form of lower prices or of improved quality of service or a combination of the two.

### ***Role of the thresholds***

- 3.7 There are three key steps in the targeted control regime. The first step is to set the thresholds for declaration of control. Step two requires the Commission to assess compliance with the thresholds and identify the lines business that is in breach of the thresholds. The third step requires the Commission to work through a process for deciding on whether or not to declare price control. The High Court observed that each of these three steps allows the Commission to achieve the “purposes” of Part 4A. The High Court observed at paragraph [25] of the Judgment:

Part 4A prescribes three steps towards achieving these purposes:

- a) Step 1: the setting (after consultation with stakeholders) of thresholds for declaration of control and the publishing of those thresholds: s 57G.
  - b) Step 2: assessing LELBs against the thresholds and identifying LELBs that breach the thresholds: s 57H.
  - c) Step 3: process for deciding whether or not to declare price control: ss 57H and 57I.
- 3.8 The High Court concluded that the Commission’s thresholds had met the statutory purpose, as set out above. Unison appealed the High Court’s findings in respect of the legality of the thresholds.
- 3.9 On appeal (paragraphs 2.34-2.36), the Court of Appeal found that the statutory purpose of the thresholds is “to perform a screening function, which, over time, should capture those who are potential candidates for control ... in assessing compliance with the statutory purpose, the incentive effects of the threshold will be relevant”.<sup>61</sup>
- 3.10 The Court of Appeal unanimously concluded that the initial price path threshold did not meet the statutory purpose. The Court of Appeal also unanimously found that the Commission’s reset price path threshold does promote the statutory objectives because, over time, “businesses will be constrained in their ability to extract excessive profits and there will be associated incentives to improve efficiency in order to make the same revenue go further”.<sup>62</sup>
- 3.11 By a majority (Hammond and Ellen France JJ), the Court of Appeal declined to set the initial price path threshold aside. Essentially, the majority accepted the Commission’s submissions that to set aside the regime would cause considerable disruption to the industry and customers.<sup>63</sup> O’Regan J, the dissenting Judge, stated that he was not

---

<sup>61</sup> supra n 31, para 46.

<sup>62</sup> ibid, para 73. As noted above (paragraph 2.37) Unison has been granted leave by the Supreme Court to appeal against the Court of Appeal’s judgment.

<sup>63</sup> ibid, para 87.

satisfied that it was an appropriate case to decline to grant relief in relation to the initial price path threshold and that he would set it aside.<sup>64</sup>

***Basis for and scope of post-breach inquiries***

- 3.12 A breach of the thresholds gives the Commission a basis on which to investigate the business in question to determine whether the performance of the business warrants control.
- 3.13 The extent to which the threshold is breached is one of the criteria the Commission may take into account in prioritising its duties under s 57K. Other criteria include the size and recent performance of the business, and the purpose in s 57E. Once a business has breached a threshold, the Commission may then decide to prioritise its investigation into whether or not the business should be controlled.
- 3.14 In order to determine whether a business should be controlled, the Commission considers that it must have regard to the overall conduct of the business, when considered in light of the s 57E purpose statement. Accordingly, the Commission is of the view that its basis for declaring control may be unrelated to the specific cause of the breach, where the Commission identifies behaviour that is inconsistent with the s 57E purpose. The earlier High Court judgment, by upholding the Commission's ability to undertake a forward-looking inquiry, supports the Commission's position that it can make a declaration of control for a reason that may be unrelated to the circumstances of the threshold breach(es) that led to the business being identified (although s 57E concerns would still need to be present). His Honour Wild J accepted the Commission's submissions that:

... subpart 1 of Part 4A is clearly forward-looking. Section 57E provides that targeted control is "for the long-term" benefit of consumers. Furthermore, Part 5 price authorisations made following a declaration of control would be made in relation to on-going prices, and would not be retroactive. A business's future pricing proposals are therefore highly relevant to any declaration of control and it is appropriate therefore for control decisions to be made in the light of such information. Control is not a backward-looking punishment for a threshold breach but a forward-looking measure to fulfil the s 57E criteria for the long-term benefit of consumers.<sup>65</sup>

- 3.15 In identifying a number of key features of the targeted control regime, Wild J made the following observation at paragraph [70] based on the common ground between the Commission and Unison:

... it is correct for the Commission, in carrying out a post-breach inquiry and deciding whether or not to impose control on [a large electricity lines business (LELB)] under Part 4A, to ask whether the LELB was extracting excessive profits, or inefficient, or failing to share the benefits of efficiency gains with consumers over the period in which the breach occurred.

- 3.16 Wild J accepted that the Commission's investigation should end if the lines business demonstrates that none of the s 57E(a)-(c) concerns exist. On the other hand, Wild J went on to conclude that, simply because a business's current performance is not consistent with the Purpose Statement, control is not necessarily the only remedy.

---

<sup>64</sup> *ibid*, para 91.

<sup>65</sup> *supra* n 30, paras [167] and [174].

It is also agreed that if, following such an assessment, the s 57E concerns are present, the Commission needs to go on and ask whether price control, with its associated costs, is needed to ensure the s 57E goals are achieved.

## **Basis for Not Declaring Control**

- 3.17 Consequently, the Commission considers that, in a general sense, control is not necessarily required to ensure that lines business performance and behaviour is consistent with the Purpose Statement. If the objectives of the Purpose Statement outlined in s 57E can be achieved by other means, then a declaration of control may be unnecessary. Such an outcome may arise, for instance, if compliance with the terms of an administrative settlement would achieve those objectives. Hence, the Commission considers it has the ability to enter into an administrative settlement with a business that has breached the thresholds, in order to further the objectives of the targeted control regime.
- 3.18 If, instead of making a declaration of control, the Commission decides to accept an administrative settlement in relation to a business that has breached a threshold, then that will involve the Commission deciding not to make a control declaration under s 57H(c) of the Act, and the Commission must publish its reasons for that decision under s 57H(d)(ii).
- 3.19 If an intention to declare control has already been published (i.e., a Stage 2 post-breach inquiry is underway)—as is the case with Unison—then the Commission considers that its decision whether to accept the settlement must be made in the context of that process. Hence, the Commission’s reasons for not declaring control would need to explain why the Commission is satisfied that settling a post-breach inquiry is at least as advantageous as control in terms of achieving the objectives in the Purpose Statement.

## **Relevant Factual and Counterfactual for Evaluating Settlement Offers**

- 3.20 As described above (paragraph 2.45), in forming an intention to declare control the Commission compares the likely outcomes under a scenario of control (i.e., the factual) with a scenario representing the likely outcomes in the absence of control (i.e., the counterfactual). In assessing the benefits to consumers of an administrative settlement, the factual becomes the outcome under the settlement and the “no control” situation remains a counterfactual scenario. Clearly acceptance and implementation of the settlement must be demonstrated to be preferable to the Commission taking no action at all.
- 3.21 In addition, as implied by the preceding discussion, if the settlement offer is received *after* the publication of an intention to declare control (i.e., during a Stage 2 post-breach inquiry), then the factual of accepting the settlement should also be compared with possible outcomes under control. Control would therefore be transformed from a factual scenario in respect of an intention to declare control, to an additional counterfactual scenario in the context of evaluating the settlement.
- 3.22 The Intention Paper explained that the Commission is mindful not to incur unnecessary administrative and compliance costs by undertaking analysis that might not be particularly material to the decision required at a particular stage of a post-

breach inquiry.<sup>66</sup> The Commission considers that such a position is also relevant to the evaluation of an administrative settlement offer. Where a settlement offer is being assessed in the context of a prior intention to declare control, then the Commission will likely be able to draw on the analysis of factials and counterfactuals that has already been undertaken, without necessarily having to redo a full updated building blocks analysis.

- 3.23 Similarly, if an administrative settlement offer is received and considered *before* the Commission forms an intention to declare control (i.e., during a Stage 1 post-breach inquiry), then acceptance of a settlement might allow the Commission to reallocate significant resources from the post-breach inquiry to other workstreams. Consequently, if the Commission's work has not yet undertaken the detailed building blocks analysis needed to identify the likely price path under control (paragraph 2.47), then the Commission considers it may be appropriate for the counterfactual to relate to the prices necessary for the business to not breach the thresholds.

## **Net Benefits of Accepting and Implementing a Settlement Offer**

### ***Net benefits of control***

- 3.24 As discussed above (paragraphs 2.43-2.44), the potential benefits of control to consumers can arise from: transfers from the lines business to consumers (resulting from any excessive profits reduced by control); the tax effect associated with reducing excessive profits; and net gains in allocative, productive or dynamic efficiency. The direct costs of control include additional compliance and administrative costs from the imposition of control, and indirect costs may arise should control lead to inefficient behaviour. For instance, control could risk impacting productive or dynamic efficiency if there were not sufficient incentives to reduce costs should the business not be able to keep the benefits arising from efficiency gains for at least a period.

### ***Reduced compliance and administrative costs from a settlement***

- 3.25 While the same general types of benefits and costs are likely to be relevant to the implementation of an administrative settlement, in the Commission's view a settlement differs markedly from control because it is initiated voluntarily on the part of the business concerned. Under an administrative settlement, the business itself takes responsibility for its performance and behaviour in a way that is consistent with the objectives of the targeted control regime, rather than the Commission being required to impose control on the business to ensure those objectives are met.
- 3.26 Because any settlement would be presented to the Commission on a voluntary basis, direct compliance and administrative costs are likely to be lower than under control (particularly given mitigated litigation risk), and the arrangement will be much less intrusive. Similarly, indirect costs are also likely to be lower, given the voluntary nature of the business's proposed actions. Therefore, a settlement may be preferable to control in a relatively light-handed regulatory regime such as the targeted control regime.

---

<sup>66</sup> Commerce Commission, *supra* n 3, paragraphs 100, 105-108 and 246.

- 3.27 However, other factors to consider are whether the extent of the risk of non-compliance with the terms of the settlement, as well as whether business performance might be more difficult to monitor than under control and, if so, the possible impacts. If a business failed to fulfil the terms of the administrative settlement, the Commission would need to identify a further breach of the thresholds to be able to recommence the process in s 57H for making a decision on a declaration of control in relation to that business. Hence, the Commission considers it appropriate for settlements to be formalised through a deed. If the business concerned contravenes any of the provisions of that deed, then the Commission may in its discretion take the necessary steps to enforce the deed.

### *Efficiency implications*

- 3.28 The Commission places significant weight on dynamic efficiency in comparison to the other dimensions of efficiency, given the importance of efficient investment to the long term benefits of consumers. This is because, over time, under-investment increases the risk that a lines business may not be able to continue to provide services at a quality that reflects consumer demands. The importance of dynamic efficiency is also emphasised in the recent GPS, which concerns the incentives of regulated businesses to invest in infrastructure (paragraphs 1.52-1.55). In particular, the GPS highlights the importance of regulatory stability, transparency and certainty for giving businesses the confidence to make long-lived investments (i.e., clause 7(a) of the GPS).
- 3.29 Where a business in breach of its existing price path threshold offers to comply with that threshold for the remainder of the regulatory period, and also to address any performance issues that led to the breach or any s 57E concerns which were identified by the Commission in its intention to declare control, it could be consistent with the Purpose Statement—and with the regulatory stability and certainty objective of the GPS—for the Commission not to control prices to a lower level. Such might be the case even if profits were to exceed the business's WACC range over the short term. This is because the price path threshold is intended to limit excessive profits, not to remove them entirely (paragraph 1.28).
- 3.30 As discussed above (paragraphs 1.29-1.31), businesses have an incentive to outperform the efficiency gains implied by their price path threshold because, throughout the five-year regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their CPI-X price path. Allowing a distribution business to retain this higher level of returns also preserves the incentives for that business to make ongoing efficiency gains in subsequent periods.
- 3.31 As a result, consumers will benefit more because the level of efficiency gains available to be shared over subsequent regulatory periods—when the thresholds are reset in 2009—will be greater. Therefore, the long-term efficiency benefits to the consumers supplied by that business might outweigh any additional short-term benefits which could be realised by those consumers if controlled prices were lower than the existing price path threshold levels.
- 3.32 On the other hand, requiring profits to be shared more immediately than that implied by a business's X factor (i.e., before the end of the current regulatory period) may in

some circumstances risk dampening future incentives for that business to invest and improve efficiency, thereby potentially reducing benefits to consumers in the longer term. This is because the business's profit expectations were based on the price path set at the outset of the period. Nevertheless, depending on the specific circumstances, the Commission might find that it would be consistent with the Purpose Statement to require profits to be shared sooner.

### ***Indirect benefits from regulatory stability***

- 3.33 The Commission notes that there are likely to be important signalling implications for the Part 4A regulatory regime from the various possible outcomes of an administrative settlement negotiation. Where a business commits to complying with its existing price path threshold for the remainder of the regulatory period, and any identified performance issues have been or will clearly be addressed, there may be significant indirect benefits from accepting and implementing a settlement as opposed to imposing control. This is because there may be positive impacts on both investment incentives and incentives to improve efficiency for the wider industry stemming from the regulatory certainty inherent in not varying from a medium-term (i.e., five-year) price path. Such indirect benefits to the industry as a whole may further outweigh any short-term benefits to the consumers of any single business from lower controlled prices.

### ***Possible alternative outcomes***

- 3.34 Nevertheless, what might be acceptable to the Commission as part of a settlement cannot be seen as a proxy for the terms on which control might subsequently be imposed, should a settlement not be able to be reached. If there is no alternative but to impose control on a business, then it is possible that any excessive profits could be shared with consumers earlier, while still preserving incentives for future efficiency gains. The control period is, however, likely to be set by the Commission for a number of years in order to provide regulatory stability and to maintain investment incentives.
- 3.35 A different outcome might arise if the Commission's post-breach inquiry were to find evidence that the price path threshold is not of itself sufficiently high to maintain appropriate investment incentives. As a result, the Commission might consider consulting on resetting the threshold upward (either on its own initiative, or as a consequence of evaluating a proposed settlement offer), even before the end of the current regulatory period.

## **Views of Interested Parties**

### ***Role for administrative settlements***

- 3.36 No submissions on the Commission's Draft Decision Paper suggested that administrative settlements, in a general sense, are an inappropriate means for resolving a post-breach inquiry of a lines business that has breached the thresholds. In fact, some submitters expressed strong support for the approach.
- 3.37 For instance, Vector supported administrative settlements as a means of resolving breaches, and indicated its view that such settlements are likely to produce better long-

term outcomes for consumers and lines businesses than control. Likewise, Orion submitted that it continues to support the Commission's process which provides for an administrative settlement as an alternative to control. CC93 also submitted that, in principle, settlements can be a lower cost and better outcome than control.

***Net benefits of accepting and implementing a settlement offer***

- 3.38 A number of submissions commented on the Commission's assessment of the types of net benefits generally associated with accepting and implementing an administrative settlement offer. For instance, Vector submitted that it is essential for the Commission to have regard to investment issues when considering whether to declare control of a lines business which has breached a threshold. Consequently, Vector argued that the Commission should give greater weight to dynamic efficiency considerations relative to other types of efficiency.
- 3.39 In this regard, Vector emphasised the importance of regulatory certainty to investment, and submitted that a decision which imposes an effective reduction in the price path threshold before the end of its term is likely to create uncertainties that undermine incentives to invest or improve efficiency, unless the variation is by consent. Vector concluded that the benefits of a stable and predictable regulatory environment will generally outweigh the short-term benefits to consumers arising from a decision to impose control of a company that proposes to abide by the thresholds.
- 3.40 Orion submitted that the Commission's emphasis on providing signals in relation to investment and efficiency incentives, together with the Commission's commitment to a medium-term price path, indicates that the thresholds may be much more than just a "screening mechanism" (where compliance with them is offered as terms for an administrative settlement). Orion stated its assumption that the approach taken in Unison's case does not foreclose the possibility that in some future cases administrative settlements may be reached for prices in excess of the threshold, and these would logically involve a need to reset the threshold in question.
- 3.41 However, Orion acknowledged that the Commission had indicated it is open to resetting a price path threshold upwards, before the end of the regulatory period, if it were to find evidence that the threshold is not of itself sufficiently high to maintain appropriate investment incentives (paragraph 3.35). Orion indicated that it welcomes this approach, because it may reduce unnecessary breaches and associated costs where a lines business can present such evidence in advance of a breach situation.
- 3.42 In addition, Orion agreed that the Commission's approach of allowing a distribution business to retain a higher level of returns for a period, in order to preserve the incentives for that business to make ongoing efficiency gains, is consistent with s 57E(a) of the Act. Orion also agreed with the Commission that greater weighting should be given to dynamic efficiency.
- 3.43 Vector and Orion both acknowledged that the extent to which the benefits of efficiencies should be shared with consumers will be considered by the Commission at the 2009 threshold reset. Vector also observed that that process will be informed by

the outcome of the review of Parts 4, 4A and 5 currently being undertaken by the Ministry of Economic Development (MED).<sup>67</sup>

- 3.44 MRP submitted that, while that GPS does not require the Commission to guarantee that regulated businesses recover their WACC, the Commission should operate price control in a way that would enable an efficient service provider to earn a normal rate of return equal to its WACC, so that the business can recover the cost of future investment. MRP noted its assumption that this is what is meant by the statement in the GPS in regards to “regulated rates of return being commercially realistic”.
- 3.45 However, MRP also submitted that, in the context of s 57E, “commercially realistic” could also be taken to indicate that lines businesses which improve efficiency and share those efficiency gains with end users should be able to earn commercial returns in excess of WACC, at least for a limited period. On the other hand, MRP submits that Part 4A does not mandate a regime which allows inefficient lines businesses to recover their WACC.
- 3.46 The Commission notes that none of the submissions discussed above provided any specific recommendations for possible changes to the Commission’s proposed framework for evaluating administrative settlements. However, as is discussed later in this paper (paragraphs 4.60-4.114), submissions differed in the views expressed concerning the merits of settling in Unison’s particular case.
- 3.47 In addition, the Commission notes a general theme throughout many of the submissions in respect of the importance of retaining investment incentives. The Commission considers that the weight it has given to dynamic efficiency in the context of evaluating administrative settlements—both generally, and in Unison’s specific circumstances—is appropriate. In the Commission’s view, the proposals set out above (paragraphs 3.28-3.35) in respect of evaluating settlements, committing to existing thresholds, or revising thresholds upward if warranted, all generally contribute to regulatory certainty and, in Unison’s specific case, the Commission has carefully considered the company’s investment needs (paragraphs 4.23-4.34).

## Summary

- 3.48 In sum, having taken into account the submissions from interested parties, the Commission considers the following factors are relevant to assessing the net benefits to consumers from implementing an administrative settlement:
- direct benefits from transfers to consumers, primarily resulting from the settlement reflecting a lower level of returns than would be the case if the Commission took no further action;
  - any foregone short-term benefits to consumers stemming from a settlement that transfers a smaller proportion of excess returns to consumers than would control;
  - the potential for even greater benefits available to be shared with consumers when the thresholds are reset in 2009 as a result of maintaining regulatory commitment to a medium-term price path, as long as the business concerned

---

<sup>67</sup> Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986, Discussion Document*, April 2007.



commits to addressing any performance issues that led to the breach and/or any s 57E concerns which were identified by the Commission in its intention to declare control;

- net changes in dynamic/productive/allocative efficiency, including impacts on service quality (e.g., indirect benefits to the industry as a whole, where investment incentives are maintained through regulatory stability over the medium term);
- direct and indirect benefits from the comparatively lower compliance costs and less intrusive nature of implementing a settlement versus imposing control; and
- any detriments to consumers associated with the risk of non-compliance by the business with the settlement terms.

## 4 EVALUATION OF UNISON'S SETTLEMENT OFFER

- 4.1 This section presents the key elements of Unison's administrative settlement offer of 31 August 2006, as amended by its letters of 13 September and 18 October 2006 (Revised Offer), and the Commission's evaluation of that Revised Offer.

### Overview of Unison's Revised Offer

#### *Key settlement terms*

- 4.2 As described above (paragraphs 2.57-2.58), the main thrust of Unison's Revised Offer is that the company planned to voluntarily reduce its average prices for electricity distribution services from 1 December 2006 to comply with its existing price path threshold for the remainder of the current five-year regulatory period (i.e., ending on 31 March 2009). Unison's offer also involves rebalancing its line charges to different regions and customer groups, so that the prices paid by consumers better reflect the costs of supplying them. This tariff rebalancing involves two stages, with the first stage already completed on 1 December 2006, and the second stage completed on 1 April 2007 (paragraph 4.22).
- 4.3 The Revised Offer has the qualification that it is made without prejudice to Unison's position in respect of its judicial review application of the threshold decisions (paragraphs 2.32-2.33). The Commission acknowledges this qualification. As noted above (paragraph 2.37), Unison has been granted leave by the Supreme Court to appeal against the Court of Appeal's judgment.

#### *Consistency with the Purpose Statement*

- 4.4 In support of the Commission accepting its Revised Offer, Unison states that "the terms of the settlement proposal are consistent with the purpose of subpart 1 of Part 4A of the Commerce Act" and the company discusses each of the elements of s 57E(a)-(c) of the Purpose Statement in turn.
- 4.5 In respect of s 57E(a), Unison states that adherence to the price path threshold over the balance of the regulatory period through to 31 March 2009 limits its ability to extract excessive profits. Further, Unison draws attention to its tariff rebalancing programme as aligning returns between regions and customer groups.
- 4.6 In respect of s 57E(b), Unison contends that its capital and maintenance forecasts have been reviewed by the Commission to confirm that they are appropriate and meet consumer demand, and highlights its undertaking to report on actual versus forecast renewals spend. Unison further notes that, because the existing quality threshold will continue to apply to Unison, it will be incentivised to continue to strive to achieve the target levels of quality.
- 4.7 Finally, in respect of s 57E(c), Unison states that, in complying with the price path threshold, it is subject to the same incentives to improve efficiency and the same

sharing of benefits of efficiency gains with consumers over the settlement period as would have been the case had the threshold breaches not occurred.<sup>68</sup>

## Aggregate Pricing Proposals

- 4.8 The Revised Offer states Unison’s commitment to voluntarily implementing tariff changes from 1 December 2006 to a level that would result in compliance with the price path threshold as at 31 March 2007, had those tariffs been applied from 1 April 2006. Subsequent tariff reviews at 1 April 2007 and 1 April 2008 would likewise be undertaken to maintain compliance with the existing price path threshold.<sup>69</sup> The settlement period lasts until 31 March 2009, so that at the time of the 2009 threshold reset Unison can be assessed in the same manner as any other distribution business.
- 4.9 Unison estimates that, irrespective of the tariff changes on 1 December 2006—which it has already implemented since making the offer—the company will nevertheless still breach the price path threshold as at 31 March 2007 by around \$450,000 (in notional revenue terms), as a result of its average price levels predating the 1 December 2006 tariff change. Unison also notes that, depending on the outcome of the Commission’s Transpower post-breach inquiry, the treatment of transmission charges may also contribute to this forecast breach.<sup>70</sup>
- 4.10 The Commission agrees that, given the way that the price path threshold is specified in the Distribution Thresholds Notice, Unison will be unable to avoid incurring a breach of the “secondary” price path threshold, despite its average price reductions from 1 December 2006.<sup>71</sup> The Commission considers that, because acceptance of Unison’s settlement is consistent with the Purpose Statement, it would therefore be appropriate for the Commission to take no further action as a result of a threshold breach by Unison in 2007, as long as the breach is solely attributable to the above factors. In the Commission’s view, it should be straightforward to determine whether such is the case.

## Disaggregated Pricing Proposals

### *Pricing principles*

- 4.11 In the Revised Offer, Unison indicates that, on a regional basis, the tariff changes over the settlement period will reflect cost allocations between the regions to result in a consistent rate of return contributed by each regional network. This move is intended to address the concerns raised in the Intention Paper concerning the disparity in the

---

<sup>68</sup> Unison, supra n 4, 31 August 2006, p 20.

<sup>69</sup> *ibid*, pp 5-6.

<sup>70</sup> *ibid*, p 9.

<sup>71</sup> The secondary price path threshold, defined in Clause 5(1)(b) of the Distribution Thresholds Notice, is intended to allow distribution businesses faced with an X factor less than the CPI to increase their prices at the beginning of each assessment period, rather than having to wait until the end of that period. Conversely, the secondary price path threshold is also intended to ensure that businesses cannot raise their prices during an assessment period to a level above that allowed at the end of that period without breaching the price path threshold. In Unison’s case, the secondary price path threshold will not reflect the full extent of Unison’s average price reduction at the assessment date of 31 March 2007, because the associated price changes have occurred during the assessment period (on 1 December) rather than at the beginning of that period.

returns received from Unison's Hawke's Bay consumers and its Rotorua/Taupo consumers. However, Unison's Revised Offer goes further by addressing similar disparities between customer groups as well. Unison intends rebalancing tariffs between customer groups to "better deliver cost reflective prices", in accordance with the allocation of costs in the company's new Cost of Supply model.<sup>72</sup>

- 4.12 A full discussion of Unison's pricing methodology and Cost of Supply model is provided in Appendix A of its Revised Offer. The principles underpinning Unison's new Cost of Supply model are largely derived from the issues paper prepared by the industry-led Prices Approaches Working Group (PAWG),<sup>73</sup> and include:
- prices should encourage the efficient use of distribution services;
  - prices should encourage efficient investment and technology innovation in the provision of distribution services;
  - prices should, as far as it is efficient to do so, relate to the level of services delivered and reflect the cost structures and risks of delivering the services, and be easily understood;
  - prices should not unjustifiably discriminate between retailers/consumers;
  - changes to pricing methodology (and the rationale for them) should follow consultation with interested parties, and be widely publicised, transparent, predictable and readily verifiable; and
  - prices should satisfy legal and regulatory requirements (including those relating to low fixed user tariffs and rural price increases).<sup>74</sup>

### ***Regional pricing assumptions and impacts***

- 4.13 Unison states that its Cost of Supply model allocates costs between regions, asset groups and customer groups based on cost reflective pricing principles. Regional cost allocation has been undertaken on the basis of two regions: Hawke's Bay and Rotorua/Taupo. Unison provides a number of justifications for treating Rotorua/Taupo as a single region rather than two separate regions, as was previously the case. Unison's reasons are that:
- its development plans include strengthening the contiguity of the two networks;
  - such an approach would facilitate rationalisation of tariff structures and implementation of the Cost of Supply model where assets are shared or potentially shared between the network areas;
  - such an approach would reflect the common reliance on Siemens' outsourced services in the two network areas; and

<sup>72</sup> Unison, supra n 4, 31 August 2006, pp 10-11.

<sup>73</sup> Pricing Approaches Working Group, *Model Approaches to Distribution Pricing, Second Paper*, 2 February 2005. PAWG was funded by the Electricity Networks Association (ENA) and was established in response to a request from the Minister of Energy for the industry to establish model approaches to distribution pricing. The February 2005 report was submitted to the Electricity Commission following comments from distribution businesses, retailers and consumer representatives on an earlier draft (August 2004), given that the Electricity Commission is expected to develop principles and model approaches to distribution pricing (Government Policy Statement in Relation to Electricity Industry Governance, October 2006, paragraph 98).

<sup>74</sup> Unison, supra n 4, 31 August 2006, pp 21-22.

- the Transpower line which feeds electricity between Taupo and Ohaaki results in consumption from Rotorua customers in the Ohaaki region contributing in part to the transmission costs in the Taupo region (and this amount cannot be readily determined).<sup>75</sup>
- 4.14 Unison's methodology generally follows the key steps outlined by PAWG, although not all the same cost drivers are used (e.g., Unison allocates non-attributable maintenance costs by line length rather than by optimised replacement cost). For regional cost allocation, Unison explains that some costs are specifically incurred on a regional basis, whereas others are allocated to regions on the basis of cost drivers such as relative system length (km), relative peak demand (MW), relative energy consumption (GWh) or relative ODV. Indirect or overhead costs are allocated to customer groups (and therefore also to regions) based on the relative number of connections (ICPs).<sup>76</sup>
- 4.15 Unison notes that the reduction in charges to Taupo and Rotorua consumers implemented from 1 April 2006 (paragraph 2.55) resulted in an average \$46/ICP fall in charges in Taupo, and a \$40/ICP fall in Rotorua. Regional tariff rebalancing consistent with Unison's new Cost of Supply model results in a further reduction of \$14 per consumer on average in both Rotorua and Taupo over the settlement period. In contrast, on average, Hawke's Bay consumers will see a reduction of around \$1 each over the settlement period. However, notwithstanding that the overall movement in all regions is a reduction some customer groups will face increases.<sup>77</sup>
- 4.16 The Commission notes that the average reductions from the price changes already made by Unison on 1 April 2006, combined with the changes implemented as part of the Revised Offer, are not as sizeable as the potential price impacts of control presented in the Intention Paper.<sup>78</sup> Reasons for this difference include the following:
- after the publication of the Intention Paper, Unison presented evidence that the regional revenue data it had previously provided to the Commission were incorrect, and therefore the disparities between the returns received from its Hawke's Bay, Rotorua and Taupo consumers were not as significant as that suggested by the Intention Paper;<sup>79</sup>
  - since the Intention Paper was published, Unison has provided evidence to the Commission that its capital and operating expenditure projections were both underestimated by more than 20% (paragraphs 4.31 and 4.39); and
  - a price path which is acceptable as part of a settlement should not be seen as indicative of the price path the Commission might allow if a settlement cannot be agreed and control is imposed (paragraph 3.34). (While the Commission might seek to share past efficiency gains with consumers sooner under control than under a settlement, the Commission cannot pre-determine the form and nature of control, and the terms of any authorisation under Part 5 of the Act would be subject to further consultation).

---

<sup>75</sup> *ibid*, p 10.

<sup>76</sup> *ibid*, pp 22-43.

<sup>77</sup> *ibid*, p 12.

<sup>78</sup> Commerce Commission, *supra* n 3, paragraph 271.

<sup>79</sup> Commerce Commission, *Commerce Commission Conference on the Intention to Declare Control of Unison Networks, Transcript*, 6 December 2005, pp 143-144.

### *Customer group pricing assumptions and impacts*

- 4.17 In the Revised Offer, Unison proposes that both Hawke's Bay and Rotorua/Taupo regions will continue to have five customer groups: unmetered, mass market, small commercial, large commercial, and industrial. Unison's Cost of Supply model allocates indirect/overhead costs based on the relative number of ICPs in each customer group. Within each region, load specific costs (i.e., transmission charges, commercial and customer relations costs, and Electricity Commission levies) are allocated by coincident peak demand (kW) or consumption (kWh) as appropriate.
- 4.18 Within each region, asset specific costs (i.e., maintenance and operations costs not already allocated elsewhere, depreciation, cash tax plus interest tax shield, and net return) are split into four asset classes—consumer specific assets, non-consumer specific high voltage assets (11kV and 33kV), low voltage assets (400V), and streetlighting assets—based on relative optimised depreciated replacement cost (ODRC). This split is intended to ensure that customer groups are only allocated costs related to assets which those groups actually use. The costs for each of the four asset classes are then allocated to customer groups based on the group's share of the coincident peak demand related to those classes.
- 4.19 Unison considers that the pricing impacts are best assessed in terms of \$/ICP for mass market customers and in c/kWh for other customer groups. Table 2 shows Unison's estimates of the average price reductions needed for its tariff schedule to be consistent with its new Cost of Supply model, but presents them on both bases.
- 4.20 In rate of return terms, estimates of the absolute change in the percentage return on investment (ROI) needed for consistency with Unison's new Cost of Supply model are shown in Table 3. The most significant reduction in the returns contributed by each customer group is intended to occur for large commercial consumers in Rotorua/Taupo (i.e., -8.1%), whereas the most significant increase is intended to occur for small commercial consumers in Hawke's Bay (i.e., +4.0%).

**Table 2: Unison's Estimates of Average Tariff Changes\***  
(from changes made by Unison on 1 December 2006 and 1 April 2007)

Customer Group	Rotorua/Taupo			Hawke's Bay			Total Unison		
	\$/ICP	c/kWh	Change†	\$/ICP	c/kWh	Change†	\$/ICP	c/kWh	Change†
Unmetered	110	0.2*	+3.1%	-398	-1.8*	-22.9%	-323	-1.1*	-16.1%
Mass market	9*	0.1*	+2.4%	-33*	-0.4*	-7.5%	-16*	-0.2*	-3.9%
Small Commercial	64	0.2*	+4.2%	632	1.1*	+39.4%	242	0.6*	+15.7%
Large Commercial	-7,563	-0.9*	-36.8%	2,565	0.4*	+19.6%	-1,011	-0.1*	-6.4%
Industrial	0	0.0*	0.0%	0	0.0*	0.0%	0	0.0*	0.0%

\* Unison's own estimates. Other values have been derived from Unison's data.<sup>80</sup>

† % changes are to the *distribution* component of allocated revenue (i.e., excluding transmission charges)

<sup>80</sup>

Unison, supra n 4, 31 August 2006, pp 10-14 and 23-46.

**Table 3: Estimated Return on Investment (ROI) Movement  
Needed to Achieve Consistent Returns**

<b>Customer Group</b>	<b>Rotorua/Taupo</b>	<b>Hawke's Bay</b>	<b>Total Unison</b>
Unmetered	+0.4%	-4.3%	-2.7%
Mass market	+0.5%	-1.5%	-0.8%
Small Commercial	+0.6%	+4.0%	+1.9%
Large Commercial	-8.1%	+2.2%	-0.9%
Industrial	0.0%	0.0%	0.0%

4.21 These values are not the percentage change in ROI, but the estimated absolute difference between the pre-December 2006 ROI (in percent) and Unison's target ROI (in percent) for each customer group when determined consistently on Unison's basis (for cost allocation purposes). Unison's return on investment target is 4.6% in real terms for all customer groups—again, for cost allocation purposes. This target is not directly comparable to the WACC or to the Commission's ROI calculation for a number of reasons, including: Unison's target is in real rather than nominal terms; it excludes revaluation gains and capital contributions; and depreciation is determined on the basis of accounting depreciation rather than ODV depreciation—the latter being approximately \$4 million lower.<sup>81</sup> Nevertheless, because the current ROI and the targets have been determined on the same basis, the table presents a reasonably accurate estimate of the absolute movement in ROI required to ensure the returns contributed by each customer group will become consistent, on the basis of the allocators used in Unison's Cost of Supply model.

4.22 The Revised Offer does not explicitly indicate the extent of the necessary rebalancing at each of the 1 December 2006, 1 April 2007 and 1 April 2008 dates. However, the Commission confirmed with Unison that all the rebalancing changes were intended to be implemented on 1 December 2006, with the exception of changes for the mass market and large commercial customer groups in Rotorua/Taupo, which would follow on 1 April 2007, given concerns from some retailers as to a 1 December 2006 rebalancing date.<sup>82</sup> The Commission considers this staged proposal to have been a pragmatic response to retailers' concerns given that the two tariff change dates were only a few months apart. Unison's 1 December 2006 and 1 April 2007 price changes subsequently took place as planned.

<sup>81</sup> *ibid*, pp 11-13. While a full building blocks calculation is not possible, given the level of detail presented in the Revised Offer, an estimate can be made of the likely equivalent range for Unison's target ROI in nominal terms. Transforming the 4.6% real rate of return target into a nominal return on investment value gives 7.1% (using a conservative CPI of 2.5% applied to Unison's own estimate of its average asset value, i.e., \$357.7 million). Including capital contributions as revenue increases the ROI to 8.0% (if the same level of contributions for 2006/07 is used as in the Intention Paper, i.e., \$3.1 million). Adjusting for the different treatment in depreciation (which Unison suggests differs by around \$4 million) raises the nominal ROI value to 9.1%. This range of nominal ROIs suggests that currently Unison is making at least a commercial realistic return—consistent with clause 7(b) of the GPS—following on from a number of recent years where the returns have been higher (Commerce Commission, *supra* n 3, paragraphs 200-218).

<sup>82</sup> Unison, *supra* n 4, 18 October 2006.

## Investment Proposals

### *Capital expenditure targets*

- 4.23 The Intention Paper did not raise any specific concerns in respect of Unison's planned capital expenditure. However, the Commission is mindful that—under either control or a settlement—the business in question should, on the one hand, be able to undertake a level of investment consistent with providing distribution services at a quality that reflects consumer demands and, on the other hand, be accountable for making that level of investment. Therefore, as part of evaluating Unison Revised Offer, the Commission has reviewed Unison's capital expenditure projections and acknowledges the voluntary commitments made by the company in respect of its planned expenditure.
- 4.24 The Revised Offer presents Unison's capital expenditure targets over the settlement period, and draws attention to the fact that the targets represent a further increase in expenditure levels over the level of previous years. Forecast capital expenditure is broken down into four components: customer-driven network extension; network capacity and security augmentation; asset renewals; and underground conversion expenditure.<sup>83</sup> A discussion of Unison's asset management approach and practices are presented in Appendix B of its Revised Offer.<sup>84</sup>
- 4.25 Under its existing price path threshold, Unison undertakes to achieve its targeted level of asset renewals expenditure outlined in its 2006 Asset Management Plan (AMP),<sup>85</sup> within the overall projected level of capital expenditure.

Unison is committed to maintaining the level of effort and expenditure directed at maintaining network performance and to maintaining the standard of asset management practices and philosophy. Unison undertakes to achieve the targeted level of renewals expenditure, within the overall projected level of capital expenditure, over the period of the settlement.<sup>86</sup>

- 4.26 Unison commits to reporting annually, in its subsequent AMPs, on the cumulative renewals spend against the forecast included within the settlement proposal.<sup>87</sup> In addition, in the context of discussing Unison's capital expenditure plans, the Revised Offer states that:

Unison's directors have considered the cash flow requirements of the business to ensure that sufficient cash is available to meet the ongoing needs of the business over the settlement period. In particular, the level of capital expenditure required by the business over the period to 31 March 2009 is discussed in section 7 and more fully in Appendix B [of the Revised Offer].<sup>88</sup>

- 4.27 Unison does highlight that the company has had problems in meeting capital expenditure targets in recent years, due to the difficulty in increasing both internal and contractor capability to process and complete the necessary level of work. Unison

<sup>83</sup> Unison, *supra* n 4, 31 August 2006, p 19.

<sup>84</sup> *ibid*, Appendix B: Unison, *Unison's Asset Management Approach, Practices and Outcomes*, Report Submitted to the Commerce Commission in Support of Unison's Settlement Proposal, 29 May 2006.

<sup>85</sup> Unison, *Asset Management Plan*, August 2006.

<sup>86</sup> Unison, *supra* n 53, p 2.

<sup>87</sup> Unison, *supra* n 4, 31 August 2006, pp 3 and 19.

<sup>88</sup> *ibid*, p 5.



contends that “considerable effort has been put into developing these capabilities and Unison intends to continue this development throughout the settlement period.”<sup>89</sup>

### ***Review of 2006 AMP and capital expenditure***

- 4.28 Throughout much of the post-breach inquiry into Unison’s performance, Parsons Brinckerhoff Associates (PBA) has provided the Commission with relevant specialist engineering and valuation advice. Following Unison’s proposal to submit a revised administrative settlement offer (paragraph 2.55), the Commission requested PBA to review Unison’s investment proposals, maintenance plans and system reliability (discussed further in paragraphs 4.38-4.40 below). PBA’s review involved a three-day site visit to Unison during the period that the 2006 AMP was being prepared. PBA’s report (2006 AMP Review) was publicly released along with the Draft Decision Paper.<sup>90</sup>
- 4.29 PBA’s 2006 AMP Review generally concluded that Unison’s plan is of good quality. However, PBA raised concerns regarding Unison’s ability to forecast and deliver its network augmentation needs, and to design and implement network development projects.<sup>91</sup>
- 4.30 For example, consistent with Unison’s own comments regarding its difficulties in meeting certain capital expenditure targets, Unison’s actual spend on network augmentation for 2005/06 was \$2.4 million against a target of \$6.5 million. While the overall capital expenditure of \$25.3 million for 2005/06 was reasonably close to the target of \$23.8 million, this is because to some extent the shortfall in network augmentation spend was offset by higher-than-forecast levels of customer-driven network extensions (i.e., an actual spend of \$10.2 million versus a forecast of \$4.3 million).<sup>92</sup>
- 4.31 Table 4 below compares Unison’s forecast capital expenditure in the Revised Offer (which is derived from its 2006 AMP) with Unison’s forecast capital expenditure in its 2005 AMP, as well as in Unison’s Initial Offer (which was modelled as Scenario 2 in the Intention Paper).<sup>93</sup> The table indicates that Unison’s capital expenditure targets were higher in its 2005 Initial Offer than in its 2005 AMP, and that since the Intention Paper was released the targets in the Revised Offer and 2006 AMP have all been further revised upwards (with the exception of expenditure on underground conversion). Total capital expenditure over the settlement period is 22% higher than was forecast at the time of Unison’s Initial Offer in February 2005.

---

<sup>89</sup> *ibid*, p 19.

<sup>90</sup> PBA, *Review of 2006 Asset Management Plan, Unison Networks Ltd*, Prepared for Commerce Commission, October 2006.

<sup>91</sup> *ibid*, p 19.

<sup>92</sup> *ibid*, pp 16-17.

<sup>93</sup> As noted above (paragraph 2.49), the capital expenditure projections used in the Intention Paper were the same in both the counterfactuals and factuals of both Scenarios 1 and 2.

**Table 4: Comparison of Unison's Recent Capital Expenditure Projections (\$000)**

Year Ending 31 March	2007	2008	2009	Total 2007-09
<b>Asset Renewals</b>				
2005 AMP	11,285	11,599	10,880	33,764
2006 AMP/Revised Offer	13,800	15,800	17,500	47,100
<b>Network Augmentation</b>				
2005 AMP	3,068	2,653	3,256	8,977
2006 AMP/Revised Offer	5,600	6,273	5,286	17,159
<b>Network Extension</b>				
2005 AMP	4,380	4,436	4,512	13,328
2006 AMP/Revised Offer	6,200	6,200	6,200	18,600
<b>Underground Conversion</b>				
2005 AMP	4,154	4,132	3,449	11,735
2006 AMP/Revised Offer	1,500	1,500	1,500	4,500
<b>Total Capital Expenditure</b>				
2005 AMP	22,887	22,280	22,097	67,804
2005 Initial Offer	25,375	22,932	23,301	71,608
2006 AMP/Revised Offer	27,100	29,773	30,486	87,359

- 4.32 The main driver of the increase in capital expenditure over the settlement period—and when compared to the Initial Offer—is an increase in Unison's forecast renewals expenditure, corresponding to a total spend of \$47.1m (i.e., \$13.8m in 2006/07, \$15.8m in 2007/08, and \$17.5m in 2008/09, up from an actual spend of \$8.8m in 2005/06). These figures have been based on modelling undertaken for Unison by LeverEdge, using an approach to estimating the level of renewal capital originally presented to the Commission as part of Unison's submission on the Intention Paper.<sup>94</sup>
- 4.33 PBA accepted Unison's underlying conclusion that asset renewal costs must be significantly increased above historical levels. Nevertheless, PBA considered that there is scope to reduce the asset renewal budget below the level proposed by LeverEdge without significantly impacting the level of supply reliability. Therefore PBA suggested that the LeverEdge analysis be considered the upper bound of an acceptable range of asset renewal expenditure.<sup>95</sup>
- 4.34 On the other hand, PBA has also reviewed the top-down methodology used by Unison to forecast its network augmentation requirements and considered that—in contrast to the asset renewals forecasts—it may understate the requirement over the medium to longer term. In PBA's view, this is consistent with the fact that expenditures higher than the average requirement of \$4.9 million per year have been forecast through to 2008/09.<sup>96</sup> In complying with its existing price path threshold, Unison will still be free to make its own decisions regarding any trade-off that might be warranted between its asset renewal and its network augmentation expenditure (as well as more generally between capital and maintenance expenditure).

<sup>94</sup> LeverEdge, *Report on Efficient Investment of Renewal Capital*, Prepared for Unison Networks Limited, 21 October 2005, from Appendix L, Unison, *Submission by Unison Networks Limited on Regulation of Electricity Lines Business, Targeted Control Regime, Intention to Declare Control*, October 2005.

<sup>95</sup> PBA, *supra* n 90, p 14.

<sup>96</sup> *ibid*, p 16.

## Quality Proposals

### *Quality threshold compliance*

- 4.35 At the time the Intention Paper was published, Unison's past breaches of the reliability criteria of the quality threshold had not yet been investigated (paragraph 2.12). In the Revised Offer, Unison contends that the settlement should resolve Unison's past quality breaches on the basis that it has applied and continues to apply sound asset management practices which have been reviewed for the Commission by PBA (paragraph 4.28). In addition, Unison states its belief that the reliability criteria of its quality threshold have been set too low, as a result of inadequate data quality and completeness over the five-year benchmark period (from 1999-2003) stemming from the acquisition of UNL's Rotorua and Taupo assets.<sup>97</sup> Unison supports this position with a report from LECG which is included as Appendix C to the Revised Offer.<sup>98</sup>
- 4.36 As a result, Unison suggests that it might continue to breach the quality threshold over the settlement period, and is already likely to do so as at 31 March 2007 due to severe storms in June 2006. Unison indicates that it is preparing information for the Commission to substantiate that these storms represent extreme events and should therefore be discounted when the Commission reviews threshold compliance for the current threshold assessment period.<sup>99</sup>
- 4.37 Nevertheless, Unison reaffirms its commitment to "maintaining the level of effort and expenditure directed at maintaining network performance," and highlights that the level of planned direct maintenance expenditure and capital expenditure is planned to increase in order to contribute to improved reliability. Unison concludes that it is confident that the strategies put in place in 2005/06, and reflected in its 2006 AMP, will have a positive influence on SAIDI and SAIFI in future reporting periods. Finally, Unison acknowledges that the Commission intends retaining the existing quality threshold for the remainder of the settlement period.<sup>100</sup>

### *Review of maintenance expenditure and system reliability*

- 4.38 Given that PBA was already examining related aspects of Unison's performance as part of its 2006 AMP Review (paragraph 4.28), the Commission requested PBA to also assess Unison's reliability and service levels, in light of the company's past breaches of the quality threshold. In particular, PBA considered the relationship of Unison's capital/maintenance practices and expenditure projections to the company's plans for maintaining and improving reliability, as well as Unison's claim that its reliability criteria of the quality threshold had been set too low.
- 4.39 Like capital expenditure, Unison's maintenance expenditure forecasts in the 2006 AMP have increased since its 2005 AMP (i.e., 23% over 2006/07 to 2008/09).<sup>101</sup> In its 2006 AMP Review, PBA observed that, up until Unison's 2006 AMP, the company had expected maintenance expenditure to stabilise and then decrease over time. PBA

<sup>97</sup> Unison, *supra* n 4, 31 August 2006, p 15.

<sup>98</sup> *ibid*, Appendix B4: LECG, *Recommended SAIDI & SAIFI Levels for the Quality Thresholds of Unison Networks Ltd*, 29 May 2006.

<sup>99</sup> *ibid* p 9.

<sup>100</sup> *ibid*, pp 18 and 20.

<sup>101</sup> PBA, *supra* n 90, p 12, Table 5.

expressed its view that the subsequent increase in the forecast is nevertheless appropriate, because ongoing expenditure on network maintenance is needed to improve SAIFI. PBA concluded that Unison's maintenance expenditure budget in the 2006 AMP is appropriate. Operations and maintenance activities are well managed and carefully planned with the result that expenditure is well targeted.<sup>102</sup>

- 4.40 Overall, PBA's key findings and recommendations with respect to Unison's system reliability were that:
- no change is warranted to the reliability criteria of Unison's quality threshold, because Unison's reliability is expected to improve over time in response to the increased level of planned expenditure, and holding the criteria at their present levels will place incentives on Unison to ensure that the additional expenditure is efficient and appropriately targeted;
  - no further action from the Commission is currently required in respect of Unison's past breaches of the reliability criteria of the quality threshold, because Unison's current asset management practices in respect of the management of its maintenance and asset renewal budgets are appropriate and are in accordance with good industry practice; and
  - the Commission should monitor the adequacy of Unison's maintenance, asset renewal and network augmentation budgets in particular, and the efficiency and effectiveness with which all three budgets are managed, given that all three areas impact system reliability.<sup>103</sup>

## Net Benefits Assessment

### *Relevant factual and counterfactual*

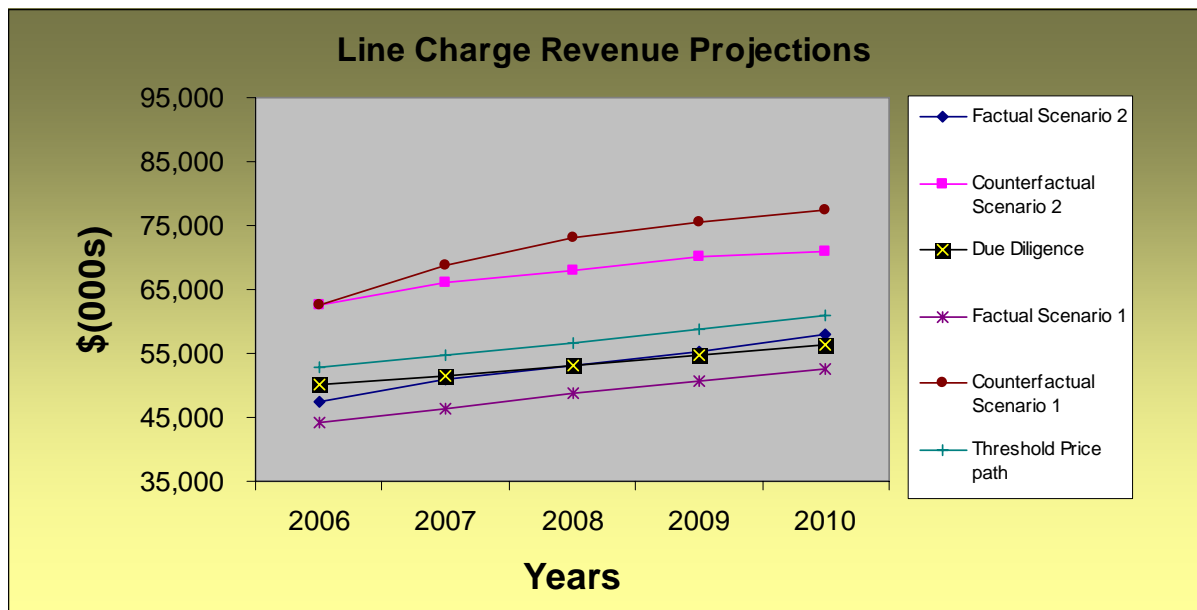
- 4.41 In its Intention Paper, the Commission applied the analytical framework and approach outlined in its Guidelines in order to assess the allocative, productive and dynamic efficiency implications of controlling Unison's electricity distribution services, as well as the transfers from Unison to its consumers that would arise from reduced excess returns under control. The Commission's preliminary findings were that significant benefits would result from controlling Unison, but the Intention Paper also implied that significant (if somewhat less) benefits from transfers would result from Unison complying with its existing price path threshold.
- 4.42 Figure 2 shows Unison's distribution charge revenue paths (i.e., excluding revenue from capital contributions) that were presented in the Intention Paper. As noted above (paragraph 2.49), Counterfactual Scenario 1 related to the expected revenue primarily associated with Unison's 2004 Statement of Corporate Intent (SCI), whereas Counterfactual Scenario 2 related to Unison's Initial Offer of February 2005. The graph also includes Unison's revenue expectations at the time it undertook due diligence for the acquisition of the Rotorua/Taupo network assets, as well as estimated revenue projections corresponding to Unison's existing price path threshold, based on conservative forecasts for demand growth.<sup>104</sup>

---

<sup>102</sup> *ibid*, pp 12-13.

<sup>103</sup> *ibid*, pp 19-20.

<sup>104</sup> Commerce Commission, *supra* n 3, pp 65-66 and Figure 5.

**Figure 2: Distribution Charge Revenue Projections in the Intention Paper**

Note: **Counterfactual Scenario 1** corresponds to Unison's possible revenue in the absence of control as presented in the Intention Paper (paragraphs 4.42-4.43 & 4.45). For the purposes of this paper it proxies a counterfactual relevant to the evaluation of Unison's Revised Offer (paragraph 4.50).

**Counterfactual Scenario 2** corresponds to revenue projections in Unison's Initial Offer of February 2005, which in the Intention Paper was considered to provide an alternative counterfactual (paragraphs 4.42-4.44).

**Threshold Price Path** corresponds to estimates made in the Intention Paper of the revenue permitted under Unison's existing price path threshold (paragraph 4.42). For the purposes of this paper it proxies the factual revenue path over the settlement period, given that compliance with the price path threshold is the basis of Unison's Revised Offer (paragraph 4.49).

**Factual Scenario 1** corresponds to the Commission's estimates of controlled revenue in the Intention Paper based on Unison's projections of capital and operating expenditure in 2004, consistent with those used in Counterfactual Scenario 1 (paragraph 2.49).

**Factual Scenario 2** corresponds to the Commission's estimates of controlled revenue in the Intention Paper based on Unison's more up-to-date projections of capital and operating expenditure, consistent with those used in Counterfactual Scenario 2 (paragraphs 2.49 & 4.51). For the purposes of this paper, it proxies an additional counterfactual scenario corresponding to control (paragraph 4.52).

- 4.43 In the Intention Paper, the Commission indicated that, in its view, neither the Scenario 1 nor Scenario 2 revenue paths necessarily reflected a true counterfactual position for the purposes of deciding whether or not to declare control. This was because Unison's initial counterfactual position (in Scenario 1) incorporated earlier information which was unlikely to be fully reflective of the company's position by the time of the intention.
- 4.44 In contrast, the Commission considered that Unison's second counterfactual position (in Scenario 2), which reflected Unison's Initial Offer, was clearly influenced by the prospect that Unison's prices might be controlled and was therefore not likely to be truly indicative of the company's returns in the absence of control. This was particularly considered to be the case given that Unison had subsequently suspended its previously planned price increases for April 2005 (paragraph 2.29).
- 4.45 Consequently, in the Commission's view, the first scenario was likely to be more indicative of Unison's actual behaviour in the absence of control, as it represented the

views of Unison's Board—as reflected in the company's 2004 SCI—prior to the initiation of the Commission's post-breach inquiry.<sup>105</sup>

- 4.46 In general, the Commission continues to hold the view that the most appropriate counterfactual for the purposes of considering whether to declare control (or in forming an intention to declare control) is one which reflects the most likely behaviour of the lines business in the absence of a credible threat of control. Therefore, when an administrative settlement offer is made, revenue paths associated with the offer are an appropriate alternative factual scenario, rather than a counterfactual scenario to be compared to a factual representing likely outcomes under control.

***Net benefits of the Revised Offer versus a “no control” counterfactual***

- 4.47 As discussed above (paragraphs 3.20-3.21), once an intention to declare control has been published, a settlement offer represents a factual scenario to be compared against both (1) a counterfactual scenario of no control, and (2) an additional counterfactual scenario of control. The Commission is mindful not to incur unnecessary administrative and compliance costs by undertaking analysis that might not be particularly material to the decision required at a particular stage of a post-breach inquiry (paragraph 3.22). Because Unison's Revised Offer is being assessed in the context of the Commission's prior intention to declare control, the Commission has drawn on the analysis of the factual and counterfactual scenarios already presented in the Intention Paper (as discussed above and shown in Figure 2).
- 4.48 In comparison to a no control scenario—in which the Commission would take no action at all in response to Unison's threshold breaches—substantial benefits to Unison's consumers have already been achieved, arising from Unison's modified behaviour in response to the Commission's post-breach inquiry. Most notably, Unison suspended its planned price increases to all consumers for April 2005 (paragraph 2.29), and in April 2006 the company reversed its earlier price increases to Rotorua and Taupo consumers (paragraph 2.55). As a result, under either a settlement or control, the potential level of incremental benefits that still remain available to consumers from limiting excessive profits, prior to the April 2009 threshold reset, is significantly less than was the case at the time of Unison's initial breach.
- 4.49 Nevertheless, it is evident from Figure 2 that implementing Unison's Revised Offer—which involves compliance with the existing price path threshold until the end of the current regulatory period—would still provide significant benefits through average line charge reductions to the company's consumers, when compared with a “no control” scenario.
- 4.50 Some circumstances have changed, however, since the analysis was undertaken for the Intention Paper. For instance, demand growth has exceeded the expectations outlined at the time. Hence, Figure 2 underestimates the likely revenue Unison would receive from complying with its existing price path threshold (although the price path threshold was designed to allow lines businesses to keep the benefits of demand growth). However, the impact of higher demand would likewise impact the revenue expectations associated with a counterfactual of no control (as proxied by Counterfactual Scenario 1 in Figure 2). Consequently, compliance with the price path

---

<sup>105</sup> *ibid*, paragraphs 228-229.

threshold would still provide a significant check on Unison's ability to earn excessive profits and would result in significant benefits to consumers through to the end of the current regulatory period.

***Net benefits of the Revised Offer versus a "control" counterfactual***

- 4.51 Figure 2 indicates that the revenues permitted under Unison's price path threshold would likely be higher than those under control (i.e., Factual Scenarios 1 and 2, with the latter scenario being based on the most up-to-date information at the time of the Intention Paper). This suggests that, in comparison to control, implementing the Revised Offer would cause some short-term benefits associated with reducing excess returns to be foregone (paragraph 3.30).
- 4.52 Nevertheless, since the Intention Paper was prepared Unison has revised its capital and maintenance expenditure projections upward by a significant margin—more than 20% in each case over the settlement period (paragraphs 4.31 and 4.39).<sup>106</sup> The Commission has reviewed these increased levels of expenditure and, for the most part, concluded that they are not unreasonable. Consequently, if a full building blocks analysis were undertaken the controlled revenue path (which in this context would be a counterfactual scenario) would lie some way above the Factual Scenario 2 revenue path shown in Figure 2. Despite this increase in forecast regulated revenue, Unison's investment incentives would be preserved under the settlement, given its ability to make at least a commercial return (footnote 81).
- 4.53 Unison has committed to complying with its existing price path threshold for the remainder of the regulatory period, and to addressing the other performance concerns raised by the Commission in its intention to declare control (paragraph 2.51). Hence, in the Commission's view, it would be consistent with the Purpose Statement, and with the regulatory stability and certainty objective of the GPS, for the Commission not to control prices to a lower level, even if Unison's returns would exceed its likely WACC range for the short term (i.e., until 31 March 2009).
- 4.54 As reiterated above (paragraph 3.29-3.32), the price path threshold is intended to limit excessive profits; not to remove them entirely. In committing to comply with its existing price path threshold, Unison will still have an incentive to outperform the efficiency gains implied by that threshold. Allowing Unison to retain the additional efficiency gains made during the settlement period increases the level of benefits available to be shared with its consumers when the thresholds are reset in 2009, and preserves the company's incentives for ongoing efficiency gains in subsequent regulatory periods. Hence, the Commission considers that the longer term benefits arising from maintaining the five-year price path that was set at the outset of the regulatory period are likely to outweigh any incremental short-term benefits to consumers—from now until the 2009 threshold reset—that might be foregone because controlled prices could be set lower than current price path threshold levels.

<sup>106</sup>

The Commission has not assessed the reasonableness or efficiency of Unison's non-maintenance operating expenditure as part of evaluating the Revised Offer. The Commission notes that Unison's forecast total operating expenditure has increased from \$19.5 million in the Initial Offer to \$21.4 million in the Revised Offer. Hence, not all this increase is attributable to higher forecasts of maintenance expenditure.

- 4.55 In addition, the Commission considers there are likely to be significant indirect benefits from accepting and implementing a settlement, such as Unison's Revised Offer, that involves commitment to an existing price path threshold. This is because there are likely to be positive impacts on investment and efficiency incentives for the wider industry given that it signals the Commission's regulatory commitment to a medium-term price path, thereby contributing to regulatory certainty and stability (paragraph 3.33). Such indirect benefits to the industry as a whole may further outweigh any short-term benefits to Unison's consumers from lower prices until the end of the regulatory period.
- 4.56 The Revised Offer also outlines a tariff rebalancing programme by reference to cost-reflective pricing principles developed by the industry (paragraph 4.12). Consequently, the Commission considers there are likely to be allocative efficiency improvements realised as a result of Unison voluntarily implementing that programme. In addition, the disparities between the treatment of Unison's consumer beneficiaries in the Hawke's Bay versus its other consumers in Rotorua/Taupo will be removed. The net level of allocative efficiency benefits would likely be lower if the Commission had to resort to control to achieve such outcomes, as determining and mandating a Cost of Supply model for Unison would probably be an intrusive, time-consuming and potentially controversial exercise.
- 4.57 Unison's Revised Offer was presented voluntarily and therefore direct compliance and regulatory costs are likely to be lower than under control (particularly given mitigated litigation risk), therefore achieving outcomes consistent with the Purpose Statement at a lower cost. Monitoring of compliance with the settlement is, however, important for the effectiveness of the arrangement and for the desired benefits for consumers to be achieved. Consequently, the terms of the settlement have been formalised in a Settlement Deed signed by Unison and the Commission, in which Unison acknowledges that the Commission will be monitoring compliance and may in its discretion enforce the Deed in the manner and form that it considers appropriate.
- 4.58 The Commission notes that a number of Unison's key obligations in the Settlement Deed have already been implemented as a result of the price changes which took effect on 1 December 2006 and 1 April 2007. Unison's future threshold compliance statements, combined with its disclosures under the new pricing methodology disclosure requirements, will further allow the Commission to monitor the impact of Unison's tariff rebalancing programme as well as any future changes to Unison's Cost of Supply model and the subsequent effect of those changes on tariffs. In addition, the current AMP disclosure requirements require that Unison report on actual versus forecast spend for its capital expenditure, and to explain any variances.
- 4.59 Furthermore, the Commission intends performing annual reviews of Unison's AMPs and Unison's performance against those plans over the settlement period—consistent with PBA's recommendations (paragraph 4.40). These reviews will include on-site visits and an explicit review of Unison's asset renewals, network augmentation and maintenance expenditure, as well as of the company's reliability performance. Therefore, while investment incentives will be preserved through the arrangement, monitoring will ensure that Unison reports progress on its actual versus planned investments, and for explaining any variances—consistent with the Purpose Statement and with clause 8(b) of the GPS.



## Views of Interested Parties

### *Overview*

- 4.60 In its submission on the Draft Decision Paper, Vector recommended that the Commission should accept Unison's Revised Offer. In Vector's view, Unison's agreement under the Revised Offer to comply with the thresholds indicates that Unison has accepted the thresholds set by the Commission are valid (subject to the outcome of Unison's judicial review proceedings), and welcomes Unison's agreement to reduce its prices to comply with the price path threshold as a commitment to the current thresholds regime, which Vector stated that it supports.
- 4.61 Powerco indicated its view that the Commission's approach to Unison's offer is "pragmatic yet regulatory focused", and that it appreciates the approach taken to address issues relating to Unison's cost allocation model, quality, maintenance expenditure and capital investment.
- 4.62 MRP indicated its support for the Commission working with Unison to see whether agreement on a settlement can be reached that would negate the need for Unison to be placed under price control. As the only electricity retailer making a submission, MRP highlighted that the Revised Offer contains elements that are contrary to its own Use of System Agreement with Unison—in particular, the restriction on changing line charges more than once a year, and the requirement to provide 60 days notice of any change in line charges. Despite the submitted disruption to MRP's retail operation, the company indicated its agreement to waiving its contractual rights for pragmatic reasons in the interests of its customers.
- 4.63 On the other hand, while acknowledging that control is not a trivial step, MEUG expressed concern about the level of returns which Unison would be permitted under the settlement, and some scepticism that the benefits to consumers of settling would outweigh those from control. In a similar vein, CC93 stated that the Revised Offer falls short of being reasonable for both the company and consumers, and recommended that the Commission should continue to pursue its intention to control Unison, while at the same time leaving open the option of a "more reasonable settlement" being reached.
- 4.64 CC93 suggested that a compromise settlement would involve:
- a more thorough assessment of Unison's cash flow requirements until the end of the settlement period, along with evidence from Unison to support its claim that, with prices set at the level proposed in the Intention Paper, the company could not fund an efficient capital expenditure programme through cash, equity or debt;
  - Unison proposing and accepting a financial penalty if it fails to achieve its planned capital expenditure; and
  - Unison providing an explanation of what benefits consumers will gain from the overcharging to date of over \$25 million, relative to price path threshold levels.
- 4.65 These reservations raised by MEUG and CC93 concerning the Revised Offer are discussed further below, along with other points submitted by interested parties.

### ***Return on investment***

- 4.66 In their submissions, both MEUG and CC93 drew attention to the Commission's estimate of Unison's ROI for 2006/07 at 9.1%, emphasising that this is significantly higher than the Commission's estimate of the mid-point WACC (i.e., 7.35%), and also the "upper range value" of 8.45%, presented at the time of the Intention Paper. In its cross-submission, MEUG further noted that the effect of agreeing Unison should have a target WACC of 9.1% "in perpetuity" would be to increase the valuation of the business by 24%. MEUG also presented Unison's past ROIs as disclosed under the information disclosure regime from 2003-2006, which range from 10.39% to 33.41%.
- 4.67 Unison's cross-submission responded to these views by observing that, in the context of setting a price cap, the Commission's advisor, Dr. Lally, has signalled support for using an ROI from the upper end of the WACC distribution, because the consequences of setting the ROI too low—in the form of deterring investment—are more severe than the consequences of setting it too high (in the form of imposing excessive prices upon consumers). As such, Unison concludes that an ROI greater than the mid-point of the WACC distribution is appropriate for a settlement.
- 4.68 The Commission notes that MEUG's reference to past returns of more than 30%—as disclosed by Unison under the current information disclosure requirements—does not take into account the Commission's current consultation process concerning changes to the regime to provide more appropriate and consistent measures of distribution business performance. It also does not acknowledge the detailed analysis of Unison's returns presented in the Intention Paper. Such high disclosed returns reflect the current treatment of one-off revaluation gains in the disclosure regime.<sup>107</sup> Similarly, the Commission considers it is misleading to present an estimate of the likely impact on Unison's asset valuation of achieving a particular level of returns "in perpetuity", given that the settlement only lasts until March 2009—at which time Unison's thresholds will be reset.
- 4.69 As explained above (paragraphs 4.53-4.55), the price path threshold is intended to limit excessive profits; not to remove them entirely. In the Commission's view, allowing Unison to retain the additional efficiency gains made during the settlement period increases the level of benefits available to be shared with its consumers when the thresholds are reset in 2009, and preserves the company's incentives for ongoing efficiency gains in subsequent regulatory periods. In addition, there are likely to be positive impacts on investment and efficiency incentives for the wider industry given that acceptance of the Revised Offer signals the Commission's regulatory commitment to a five-year price path.

### ***Precedent issues and remedies for past overcharging***

- 4.70 In its submission, MRP observed that Unison's Revised Offer is the first to be consulted on under Part 4A of the Commerce Act and therefore, if accepted, will provide a precedent for the way in which the Commission will deal with future breaches of the thresholds. However, MRP acknowledged that future settlements will take less time to negotiate—thereby mitigating the extent of any breaches.

---

<sup>107</sup>

Commerce Commission, *supra* n 3, paragraphs 205-208.

- 4.71 MRP also submitted that a lines business which breaches the price path threshold should only be able to retain revenue earned in excess of the threshold to the extent that the business can demonstrate that an efficient service provider would need to breach the thresholds to recover its WACC. In Unison's case, MRP—like CC93 and MEUG—noted that the cumulative effect of Unison's breaches is overcharging by about \$27 million over the five years from 2002-2007.
- 4.72 In its submission, MEUG suggested that the Commission should consider whether there is a "precedent risk" that distribution businesses—including Unison itself—will perceive acceptance of the Revised Offer as an indication that there will be very little risk of a material regulatory response if for the last one or two years of the current regulatory period they deliberately increase line charges above the threshold level.
- 4.73 Similarly, CC93 submitted that, to allow a distribution business to breach the thresholds and—in the lag between a settlement and control taking effect—to pocket the overcharged amounts without the threat of having to compensate consumers, sets a very poor precedent. CC93 stated that it "has not been impressed by Unison's behaviour to date in arguably frustrating and delaying a resolution to the threshold breaches, by way of court action and lengthy periods before settlements have been tabled, while in the meantime earning unexplained excess revenues above threshold levels and excess profits."
- 4.74 In CC93's view, acceptance of the Revised Offer would mean that "distributors will perceive breaching the thresholds and reaching a settlement with the Commission as less onerous on the companies than it should be." Consequently, CC93 submitted that, if Unison cannot provide a satisfactory answer for its overcharging of \$25 million to date, then the company should offer to pay back this overcharging as part of the settlement. In response, Unison stated its understanding that the Commission has established that the targeted control regime is not intended to be punitive, and the Commission is interested in ensuring that businesses come into line with behaviour consistent with s57E of the Act.
- 4.75 The Commission considers that, generally, neither control nor an administrative settlement is intended to compensate consumers by recovering any overcharging prior to a settlement being agreed (or control declared), but to ensure that the future performance of the business concerned is consistent with the Purpose Statement. Furthermore, as MRP acknowledged, Unison's settlement offer is the first that the Commission has consulted on. In future, the Commission may consider moving much more quickly to announce whether it intends publishing an intention to declare control on the basis of information before it.
- 4.76 The Commission also notes that acceptance of an administrative settlement offer does not necessarily create a precedent for the content and standard of future offers. In evaluating a settlement offer, the Commission evaluates whether the offer addresses the particular section 57E concerns identified by the Commission when it made its intention to declare control (or earlier if an intention has not yet been published). As such, each settlement offer will be unique to the particular business concerned. However, the Commission intends to apply the analytical framework set out in Section 3 of this paper when evaluating other settlement offers.

### *Jurisdiction on tariff rebalancing*

- 4.77 In commenting on Unison’s proposals for rebalancing its tariffs, Vector submitted that rebalancing is “outside the current thresholds regime” but stated that it is open for Unison and the Commission to agree to address tariff rebalancing as part of an administrative settlement. Like Orion, Powerco and MRP, Vector drew attention to the Electricity Commission’s responsibilities in respect of model approaches to distribution pricing as outlined in the October 2006 *Government Policy Statement on Electricity Governance* (and the prior version of that statement).
- 4.78 Powerco expressed support for the outcome offered by Unison in respect of tariff rebalancing, but stated that it does not support the means by which the Commission has sort to address concerns about rebalancing and the premise on which the intention to control Unison was based. Powerco argued that it appears the Commission has used its statutory powers to encourage Unison to cost allocate in line with PAWG’s recommendations. Powerco submitted that such an approach is undesirable because it is unclear that the Commission’s responsibilities were designed for this purpose, thereby contributing to regulatory uncertainty.
- 4.79 On the other hand, in its cross-submission, MEUG argued that excess line charges can have economic efficiency effects on the consumption and investment decisions of manufacturers. As such, MEUG—like CC93—did not agree with the view that rebalancing is not within the ambit of the Commission. Rather, MEUG stated that, to the extent cross-subsidies have economic welfare effects on consumers, rebalancing is a legitimate focus for the Commission in implementing Part 4A.
- 4.80 Similarly, CC93 submitted that tariff rebalancing has important economic efficiency effects, and because the Commission has an important role to ensure economic efficiency, rebalancing issues must be considered by the Commission. In CC93’s view, the level of line charges impacts consumers’ investment decisions concerning new appliances or machinery. In addition, CC93 highlighted the provision in Part 4A (i.e., s 57H(c)), which allows the Commission to make declarations of control in respect of all or *any* of the services supplied.
- 4.81 The Commission considers that its post-breach inquiry may encompass a wider scope than the specific cause or circumstances of any breach (paragraph 3.12). In the Commission’s view these factors all suggest that, subject to the Purpose Statement, addressing inefficiencies inherent in tariffs can be a relevant consideration for the Commission in exercising its powers under the targeted control regime. Rebalancing distribution prices can contribute to meeting the objectives in the Purpose Statement because, as MEUG and CC93 imply, poorly designed line charges can have detrimental effects on both allocative and dynamic efficiency.
- 4.82 In addition, the Commission highlights that its Draft Decision Paper acknowledged the role the Electricity Commission has in respect of distribution pricing methodologies.<sup>108</sup> The Commission recognises that, under s 57MA of the Act, it must take into account—before exercising its powers under Part 4A, or ss 70-72 in Part 5 (paragraphs 1.43-1.45)—any electricity governance regulation, rule or decision made by the Electricity Commission, including those in respect of distribution pricing

---

<sup>108</sup>

Commerce Commission, *supra* n 5, fn 59.

methodologies. However, as Vector noted in its submission, there are currently no guidelines or rules in force from the Electricity Commission for the development of distribution business cost of supply models or pricing methodologies.

### *Unison's Cost of Supply Model*

- 4.83 Vector submitted that each distribution business is required to exercise its own judgement in developing an appropriate cost of supply model, and highlighted that this is an extremely complex matter raising a wide range of issues including—among other things—the treatment of rural consumers and the effects of the *Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations 2004* (low fixed charge regulations). In Vector's view, it would be desirable for there to be a wider debate across the electricity lines industry on these issues. Similarly, Powerco stated that cost allocation is a difficult area with multiple "right answers". However, Powerco indicated that, in finding a solution that works for Unison, the reference to the PAWG recommendations is appropriate.
- 4.84 Orion noted the Commission has accepted that Unison's cost of supply model deviates from the PAWG proposals, but agreed this is appropriate because the PAWG recommendations are not definitive and are only a possible input into the Electricity Commission's work on developing model approaches to distribution pricing. Orion submitted that costs for an electricity lines business are largely driven by the overall peak load which the network must supply, together with the overall capacity which must be provided. In Orion's view, for dynamic efficiency, cost-reflective pricing should relate to these two factors.
- 4.85 MRP noted that, while the Commission's original intention to declare control of Unison examined the Hawke's Bay, Rotorua and Taupo subnetworks distinctly, the Revised Offer considers the Rotorua and Taupo regions together. MRP expressed its support for this change, because it addresses the concern that community/trust/council-owned lines businesses may have incentives to favour customers within the community/trust/council boundary at the expense of customers outside of that area.
- 4.86 On the other hand, MRP considers that, while Unison's proposed cost allocation methodology does not seem unreasonable, there is any number of different methodologies that could also be satisfactory for pricing purposes. In particular, MRP highlighted that Unison's non-region specific costs do not vary directly by customer numbers, electricity consumption or peak demand, thereby providing little or no basis for deciding to use one allocator over another.
- 4.87 MRP questioned how the Commission's focus on regional and customer group pricing advances the s 57E purpose statement, submitting that allocative efficiency gains of rebalancing are likely to be low because demand from all customers is likely to be relatively price inelastic. In particular, MRP believes that Part 4A treats wealth transfers amongst consumers, as opposed to from suppliers to consumers, as a "zero-sum" outcome, because in its view the purpose of targeted control is limited to efficiency gains that are in the long-term benefit of consumers "as a whole".
- 4.88 Furthermore, MRP submitted that, while the Commission appears to have placed weight on equalising rates of return across regions and customer groups, the resultant prices are a function of the "often arbitrary" allocators that are chosen. MRP

reiterated earlier submissions in this and other contexts regarding cost disaggregation which stressed that there are a wide range of prices which would satisfy the criteria that they do not result in excess charges (i.e., prices above stand-alone costs) or subsidies (i.e., prices below incremental cost).

- 4.89 MRP also argued that possible application of Ramsey pricing principles is made difficult by the lack of information on the price elasticity of demand for electricity by region and customer group. Specifically, MRP took issue with the Commission's view that one might expect residential consumers and many types of commercial consumers to be less responsive to changes in line charges than many industrial consumers, arguing that a greater proportion of residential demand may be discretionary and there may be greater scope for fuel substitution.<sup>109</sup> The impact of the low fixed charge regulations is, in MRP's view, another factor that distorts the likelihood that the application of Ramsey pricing principles would improve allocative efficiency.
- 4.90 In addition, in MRP's view, claims that Unison's new pricing methodology results in equal returns by region and customer groups should be taken with extreme caution. Finally, MRP suggested that the Commission's focus on returns by customer groups may discourage mergers and acquisitions, given that pricing differentials may be a legacy of pre-merger/acquisition costs and pricing methodologies.
- 4.91 In response to MRP's points, MEUG agreed that the issue of tariff rebalancing is difficult and so caution needs to be taken, but disagreed with MRP's views concerning the impact of rebalancing proposals on incentives for mergers and acquisitions. MEUG submitted that mergers and acquisitions should occur where one entity observes cost savings are possible while remaining within the thresholds. Without any threshold breach, the newly expanded entity will have time to deal with legacy tariff issues. Moreover, MEUG added that it is not sympathetic towards distribution businesses which acquire other networks at a price above ODV values and then find themselves with cash flow problems.
- 4.92 The Commission considers that the principles and assumptions underpinning Unison's new Cost of Supply model are reasonable for the purposes of this settlement given Unison's circumstances at this point in time. That model has largely been derived from principles and approaches derived by the industry itself, but modified to deal with Unison's business-specific factors. Despite a number of submitters raising some general concerns relating to cost allocation methodologies for distribution pricing, the Commission notes that no submitters provided any specific proposals for amendments to Unison's Cost of Supply model.
- 4.93 The Commission agrees that wider consultation on this issue is appropriate in the context of the Electricity Commission's work on developing consistent and common distribution pricing guidelines (or regulations as necessary) for the electricity distribution industry. In the meantime, in the context of evaluating Unison's administrative settlement, the Commission is not mandating or prescribing a particular pricing methodology. Rather, the Commission is ensuring that the voluntary proposals set out by Unison itself have been tested and made transparent through consultation with interested parties.

---

<sup>109</sup>

Commerce Commission, *Intention to Declare Control, Vector Limited*, 9 August 2006, paragraph 190.

### ***Risk differentials***

- 4.94 MEUG indicated its view that the principles being developed by PAWG were making good progress, but in Unison's case submitted it is not clear that every consumer class has identical risk such that a uniform rate of return is justified. MEUG argued that large time-of-use consumers will tend to have dedicated assets covered by bi-lateral contracts, and their share of high voltage assets will be covered by line charges with a large fixed component. In contrast, MEUG claimed that consumer classes without access to time-of-use tariffs tend to have a higher proportion of variable charges, and thereby contribute to greater revenue uncertainty than large consumers.
- 4.95 In its cross-submission, Unison agreed that, in theory, there are different levels of risk which apply to different customer classes. Unison indicated that, while the company may review its cost of supply model in future to address this issue, it has assumed a constant real rate of return in the Revised Offer for pragmatic purposes. However, Unison disputed the factors which MEUG considers contribute to lower risk in respect of bi-lateral contracts with large consumers. Unison submitted that it has very few bi-lateral contracts with consumers to secure the value of dedicated assets, and the potential for large consumers to move away from Unison's network, thereby stranding assets and contributing to a revenue shortfall, presents a higher—rather than lower—risk than smaller/domestic consumers.
- 4.96 As noted above, the Commission considers that the assumptions underpinning Unison's new Cost of Supply model, including the assumptions on risk differentials, are reasonable given Unison's current circumstances. The Commission also notes Unison's acknowledgement that its current proposal is a pragmatic approach given the level of relevant information currently available, but that the company may review the issue of risk differentials further in future. In general, where risk differentials are proposed by a distribution business, the Commission would expect such proposals to be transparently backed up by evidence supporting the appropriate extent of those differentials, and tested through consultation with interested parties.

### ***ODV and rebalancing***

- 4.97 In the context of Unison's cost of supply model, MEUG submitted that Unison's regulatory asset valuation as at 31 March 2006 appears to be overstated when compared to Unison's audited ODV valuation as at 31 March 2005, even allowing for inflation and new investment. MEUG suggested that Unison should reconcile the difference in asset value, and claims that if an ODV value based on the information disclosure requirements were used then prices for all classes of consumers in all regions would decrease relative to the Revised Offer.
- 4.98 In its cross-submission, Unison submitted that ODV replacement costs materially understate the cost of replacing assets, but provided the reconciliation requested by MEUG. Orion—like Unison—highlighted comments made by PBA in the 2006 AMP Review that, in the normal course of business, Unison installs many new assets on an incremental basis, and therefore Unison's FRS-3 valuation provides a useful basis for estimating capital expenditure budgets in the AMP.
- 4.99 In any event, Unison emphasised that its regulatory asset value is only used as the basis for allocating various values among its consumer groups—the value is not used

to set the company's revenue targets, as these are limited through compliance with the price path threshold. Consequently, a change in the valuation amount would not result in a price decrease for all consumers compared to the Revised Offer.

- 4.100 The Commission highlights that Unison's offer involves complying with its existing price path threshold until March 2009, and that price path does not change in response to changes in Unison's underlying asset value. As Unison explains, the impact of a different ODV on the offer would only potentially impact the allocation of costs to different customer classes, and then only to the extent that any change affects different customer groups on a relative basis (i.e., in different proportions), rather than on an absolute basis.

### ***Ability to invest***

- 4.101 In its submission, MRP supported the focus on investment in the Revised Offer and expressed its view that the August 2006 GPS elevates dynamic efficiency as the paramount efficiency consideration. MRP stated that, in Unison's case, it is clear from the Draft Decision Paper that the Commission had considered the GPS, because the Revised Offer does not attempt to strip out all the excess returns, and it has a clear focus on ensuring that Unison makes adequate investment in its network (with monitoring) for the remainder of the current regulatory period. In MRP's view, accepting the Revised Offer could be seen as "generous" in that it allows Unison to retain the revenue it received in excess of the price path threshold.
- 4.102 CC93 submitted that the Revised Offer provides no evidence to support the view that, if the company were controlled with revenues set at the levels in the Intention Paper, investments for future demand growth and maintenance of quality of supply would not be bankable (i.e., supported from cash flow or additional equity or debt). Unison responded to this point noting that, while the issue of bankability is not directly addressed in its Revised Offer, the issue had been canvassed in Unison's submission and cross-submission on the Intention Paper. Specifically, Unison directed CC93 to those documents which include modelling that, in its view, demonstrate the infeasibility of funding the business in the event the company's revenue streams were lower under control.
- 4.103 CC93 also highlighted that Unison has not proposed any penalties or incentives in the Revised Offer, other than the same incentives as any other distribution business to ensure prices do not exceed the threshold level and timely investment consistent with its AMP. In response, Unison reiterated that, in the Revised Offer, the company has proposed it make specific disclosures in its AMP to enable the Commission to monitor the undertaking made by Unison to achieve its renewal expenditure targets. Unison stressed that CC93 appears to overlook this undertaking and the Commission's position that Unison's AMPs, capital and maintenance expenditure, and its reliability performance would also be subject to regular reviews by the Commission.
- 4.104 In making the decision set out in this paper, the Commission considers that it is not necessary to consider any impact that a *lower* price path (as part of a threshold or under control) might have on Unison's financial position or "bankability". As noted above (paragraphs 4.53-4.55), the Commission considers there are likely to be significant direct and indirect benefits from Unison returning its prices to within its *existing* threshold, and that implementing the settlement would contribute to better



long-term outcomes for consumers than would be the case under control. In respect of the Revised Offer, Unison has indicated that, in committing to its existing price path, the company has taken into account its cash flow requirements and capital expenditure needs (paragraph 4.26), and has acknowledged that the Commission will undertake regular reviews of its expenditure and performance.

### ***Information in 2006 AMP***

- 4.105 Both CC93 and MEUG highlighted comments made by PBA in its 2006 AMP Review which identify several areas where further information or details could have been provided by Unison in its 2006 AMP, particularly in respect of asset renewals (and maintenance) expenditure. CC93 concluded that an acceptable level of disclosure by Unison has not been met to support the administrative settlement.
- 4.106 In response, Unison's cross-submission highlighted that PBA's review did not indicate there were any information deficiencies in the company's 2006 AMP which limited PBA's ability to advise the Commission on the appropriateness of the Revised Offer. Unison acknowledged that there are areas where its AMP requires further incremental improvement, and stated that it will consider PBA's observations in preparing its 2007 AMP. In addition, Unison highlighted that its 2005 AMP was ranked by Farrier Swier as the fifth best in the industry for compliance against the information disclosure requirements.
- 4.107 The Commission considers that any lack of information or detail in Unison's 2006 AMP has not impacted the Commission's review of the Revised Offer. The Commission notes that, if there were any issues concerning Unison's current or future compliance with information disclosure requirements for AMPs (or other aspects of the disclosure regime), these issues could be dealt with separately under the relevant provisions for dealing with such non-compliance in ss 57U and 57ZJ of the Act (if necessary).

### ***Quality proposals***

- 4.108 MEUG highlighted Unison's statement in the Revised Offer that the company does not intend to invest specifically to bring quality within the threshold levels, and argued that if Unison does not accept the obligation to try and achieve the quality threshold then the offer is unacceptable. In addition, MEUG submitted that Unison should be required to disclose evidence of consumer preferences regarding quality to enable an understanding of what choices between quality and line charges Unison has offered to various voltage classes of consumers, and the responses which Unison has received.
- 4.109 In its cross-submission, Unison responded to MEUG's submissions regarding quality, emphasising that MEUG is "wrong to refer to the quality thresholds as an 'obligation'". Unison stressed PBA's findings that "there is little more that Unison can reasonably do in the short term to remedy past breaches of its quality threshold". In addition, Unison reiterated its acceptance of the Commission's preliminary decision not to reset the company's quality threshold, on the basis that Unison "intends to maintain the high standard of asset management that [PBA] recognised when they visited the company as part of their review". Consequently, Unison acknowledged that it remains accountable for explaining to the Commission any future breaches of the quality threshold.

- 4.110 The Commission agrees that Unison will still be subject to the quality threshold, and therefore appropriate incentives in respect of network reliability will be retained. Furthermore, the Commission notes PBA's view that Unison's planned levels of capital expenditure are consistent with the company's reliability actually improving over time (paragraph 4.40).

### ***Net benefits assessment***

- 4.111 MEUG submitted that the direct costs of control (i.e., \$614,000 per annum) appear to be significantly less than the benefit that would accrue to consumers by mitigating Unison's intention—as set out in the Revised Offer—to continue charging prices inclusive of material excess returns.
- 4.112 Furthermore, in its cross-submission, MEUG submitted that the Commission is asking consumers to forego more than \$25 million of excess charges over the past three years, plus excess returns for the next two years, on the assumption that benefits will be shared with consumers at the 2009 threshold reset. MEUG noted that, because Part 4A of the Act is being reviewed, the Commission cannot guarantee that “it can deliver that part of the bargain” from April 2009. Consequently, in MEUG's view, this leaves consumers at risk of losing out now and from April 2009.
- 4.113 CC93 concluded that, failing a further revised settlement being negotiated, control over the remainder of the regulatory period is compelling because excess revenues over that period will be much higher than the direct costs of control. Hence, on that basis, the control option remains a credible alternative.
- 4.114 The Commission considers that submissions which focus only on the direct benefits and costs of implementing the Revised Offer do not appear to take into account the significant indirect benefits associated with the proposal, or any indirect costs associated with control. While the Commission acknowledges that it cannot make guarantees regarding any efficiency sharing mechanism to be implemented from April 2009, such guarantees would not be possible at this stage, irrespective of the review currently being undertaken by MED of Part 4A. The details of any such future proposals will require consultation with interested parties at the appropriate time.

### **Summary**

- 4.115 In general, the Commission considers that a price path threshold—when complemented by a quality threshold—is by its very nature consistent with the outcomes sought in s 57E(a)-(c) of Part 4A (paragraphs 1.28-1.32). More specifically, in Unison's case, complying with its existing thresholds going forward will: (a) limit Unison's ability to extract excessive profits, (b) provide strong incentives for Unison to improve efficiency and to provide services at a quality that reflects consumer demands; and (c) ensure Unison shares the benefits of efficiency gains with consumers.
- 4.116 With respect to s 57E(c), while some efficiency gains will be shared with Unison's consumers during the regulatory period—because the X factor in its price path threshold reflects expected average efficiency gains—the main opportunity for sharing efficiency gains will come at the end of that period (paragraphs 3.30-3.32). This is important, because allowing Unison to retain the benefits of its additional efficiency

gains made during the regulatory period, and therefore preserving the company's incentives to make ongoing efficiency gains, increases the level of benefits available to be shared with its consumers from the end of the current regulatory period, when the thresholds are reset in 2009.

- 4.117 In addition, Unison's Revised Offer is also intended to address the other s 57E concerns identified in the Commission's intention to declare control, particularly the disparity in the returns contributed by the company's Hawke's Bay and Rotorua/Taupo consumers (paragraph 2.51). In fact Unison's offer goes further because it addresses similar disparities between customer groups as well (paragraph 4.11).
- 4.118 The Commission considers that, over the regulatory period, Unison's existing thresholds provide an appropriate level of incentives for efficient behaviour over the regulatory period, and therefore the company did not need to raise its prices further and breach the price path threshold. Given that Unison has now agreed to address the performance concerns identified by the Commission, it is appropriate for Unison's existing thresholds to be retained.
- 4.119 In sum, having taken into account the submissions from interested parties, the Commission considers that the following net benefits to consumers, consistent with the Purpose Statement, would be realised from accepting and implementing the Revised Offer:
- Unison's compliance with its existing thresholds, and its commitment to addressing the s 57E concerns identified in the Commission's intention to declare control, will ensure behaviour consistent with s 57E(a)-(c) of the Purpose Statement at a lower administrative and compliance cost than control;
  - in particular, Unison's incentives to invest in order to maintain network performance will be preserved over the settlement period, as is evidenced by the company's commitment to meeting its capital expenditure targets;
  - Unison's tariff rebalancing programme will likely provide allocative efficiency benefits in a less intrusive and costly manner than would be possible under control, and has been implemented since the Commission's Draft Decision Paper was published;
  - any forgone short-term benefits to Unison's consumers, from potentially lower prices under control, are likely to be more than offset over time by the benefits arising from incentives created by allowing Unison to retain any additional efficiency gains it makes over the settlement period, because this increases the level of benefits available to be shared with its consumers when the thresholds are reset in 2009;
  - positive impacts on investment incentives for the wider industry will likely stem from the regulatory stability signals provided by the Commission in reinforcing its commitment to a medium-term price path;
  - with any settlement there is a possibility of non-compliance, but the Commission considers it will be straightforward to monitor the implementation of the settlement, and if Unison contravenes any of the provisions of the Settlement Deed, the Commission may in its discretion enforce the Deed in the manner and form that it considers appropriate; and

- Unison's asset management plans, capital and maintenance expenditure, and its reliability performance will also be subjected to regular reviews by the Commission.

## 5 DECISION NOT TO DECLARE CONTROL

### Decision Not to Declare Control of Unison

- 5.1 In its intention to declare control, the Commission outlined its view at the time that control of Unison's electricity distribution services would be consistent with the Purpose Statement. Having now evaluated Unison's Revised Offer and taken into account the views of interested parties (as is set out in the previous section), the Commission's view is that control is not necessary to address the s 57E concerns identified in the Intention Paper (paragraph 2.51), because these concerns would be appropriately addressed through acceptance and implementation of the Revised Offer.

#### *Limiting excessive profits*

- 5.2 While control would limit Unison's ability to extract excessive profits, Unison's voluntary compliance with its existing price path threshold (paragraph 4.8-4.10) will, in the Commission's view, achieve the same objective at lower administrative and compliance costs (paragraphs 4.5, 4.50, 4.53 and 4.57). Furthermore, Unison's incentives to invest to maintain network performance will be preserved over the settlement period, because the company will continue to earn at least a commercial return and the company's directors have specifically considered the cash flow requirements of the business in the context of Unison's capital expenditure projections (paragraphs 4.25-4.26, 4.37 and 4.52). In addition, monitoring by the Commission will ensure that Unison is accountable for making its planned investments (paragraph 4.59).

#### *Benefits to consumers from lower average prices*

- 5.3 The Intention Paper indicated that control would result in lower prices, on average, for Unison's consumers, particularly in Rotorua and Taupo. Since the Commission's intention to declare control was published in September 2005, Unison's Rotorua/Taupo consumers have already received benefits arising from the Commission's post-breach inquiry, because in April 2006 Unison reversed its most recent price increases to those consumers. Unison's decision to move to comply with the price path threshold in accordance with the Revised Offer, before that offer has been accepted, has resulted in additional price reductions for its consumers (on average) from 1 December 2006 (paragraphs 4.15 and 4.22).
- 5.4 In the Commission's view, any additional but forgone short-term benefits to Unison's consumers—from potentially lower prices under control—are likely to be more than offset by the benefits arising from the incentives created by allowing Unison to retain any additional efficiency gains it makes over the settlement period, because this increases the level of benefits available to be shared with its consumers when the thresholds are reset in 2009. In addition, there are likely to be positive impacts on investment and efficiency incentives for the wider industry from the regulatory stability signals provided by the Commission in reinforcing its commitment to a medium-term price path (paragraphs 4.51-4.55).

### ***Addressing the disparity in returns between Hawke's Bay and Rotorua/Taupo consumers***

- 5.5 While the Intention Paper indicated that control could address the disparity in the returns received from Unison's Hawke's Bay consumers and its Rotorua/Taupo consumers, Unison's Revised Offer goes further by addressing similar disparities between customer groups as well (paragraphs 4.11-4.22). Unison's tariff rebalancing programme—which has already been implemented in two stages on 1 December 2006 and 1 April 2007—espouses cost-reflective pricing principles, and will likely provide allocative efficiency benefits in a less intrusive and costly manner than would be the case under control, because when authorising Unison's prices for controlled services the Commission might have no option but to mandate a Cost of Supply model (paragraph 4.56).

### ***System reliability***

- 5.6 In addition to addressing the concerns raised in the Intention Paper, the Revised Offer explicitly addresses Unison's system reliability performance, which had not been investigated at the time of the Intention Paper. The Commission has now investigated Unison's past breaches of the reliability criteria of the quality threshold, as part of a wider review undertaken by PBA, and its preliminary view is that no further action is necessary, because Unison's current asset management practices relating to its maintenance and asset renewal budgets appear to be appropriate and in accordance with good industry practice (paragraphs 4.38-4.40).

### ***Commission's decision***

- 5.7 In conclusion therefore, the Commission considers that the likely outcomes associated with the administrative settlement proposed in Unison's Revised Offer are consistent with the Purpose Statement. Furthermore, over the relatively short settlement period from now until the 2009 threshold reset, acceptance and implementation of the settlement will be at least as advantageous to the long-term interests of consumers as would control. As a result, at this stage, a declaration of control in respect of Unison's electricity distribution services is not necessary to ensure that the objectives of the targeted control regime are achieved, provided the settlement is implemented. Therefore, the Commission has decided not to make a declaration of control in respect of the distribution services supplied by Unison.

### ***Next Steps***

- 5.8 Unison's Revised Offer has now been formalised through a Settlement Deed that incorporates the terms of that offer. Consequently, the Commission is able to close its post-breach inquiry into all of Unison's threshold breaches prior to 1 April 2006. In accordance with s 57H(d)(ii) of the Act, the Commission will shortly publish an overview of its reasons for not making a control declaration in the *Gazette*.