MAJOR ELECTRICITY USERS' GROUP

15 August 2014

John McLaren
Regulation Branch
Commerce Commission

By email to regulation.branch@comcom.govt.nz

Dear John

Proposed DPP for EDB from 1 April 2015

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission paper[1] "Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015", dated 4th July 2014, ie the "the DPP Main Policy paper" plus companion explanatory papers, spreadsheets and databases.

2. MEUG is submitting separately today on the Commissions "Low cost forecasting approaches for Default Price-Quality Paths" paper published 4th July 2014.

3. Two other sets of papers are also relevant. All were published on 18th July with submissions closing 29th August. First, the Quality incentives paper, the Compliance paper and text of the Draft Determination. Second, papers[2] proposing changes to Input Methodologies (IM) to apply an Incremental Rolling Incentive Scheme (IRIS) for DPP and various other non-IRIS and non-financial model IM amendments to give effect to new features of the DPP Main Policy paper proposal. MEUG may submit on these.

4. Members of MEUG have been consulted in the preparation of this submission. This submission is not confidential.

The broader context and outline of this submission

5. MEUG agrees with the intention of approaches to the DPP proposal to[3] "... generally reflect incremental improvements on the approaches that we have relied on previously." Most of the DPP proposal is familiar and appropriately carried over from the initial DPP. The focus of this submission is on the new features of the proposal. MEUG has taken a broader consideration of the benefits and costs of each new incremental approach in the context of desired longer term outcomes. Two themes kept arising in our analysis:

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[1] http://comcom.govt.nz/regulated-industries/electricity/electricity-default-price-quality-path/default-price-quality-path-from-2015/ document http://comcom.govt.nz/dmsdocument/12079
[2] http://comcom.govt.nz/regulated-industries/input-methodologies-2/amendments-and-clarifications/
[3] DPP Main Policy paper paragraph X10, pX3

a) In considering the DPP proposal it has become clear to MEUG that the s 53P(1) prohibition on benchmarking when setting DPP will lead to inferior outcomes in terms of the long-term benefit of consumers compared to allowing benchmarking; and

b) Adding ever more complexity to DPP undermines incentives on EDB to seek CPP. The fact that in 5 years only one EDB has applied for a CPP, namely Orion for catastrophic earthquake events, leads to the question as to whether the new features to the DPP proposal will facilitate or not further CPP applications. If proposed incremental changes to the DPP are in effect leading to it becoming a pseudo CPP or CPP "lite" without imposing more accountability of EDB to prove the efficiency; then MEUG suggests some of those features need to be re-considered.

6. The balance of this submission considers the DPP proposal in terms of timing, price content and quality content as required by s. 53M, the incremental changes in relation to s. 54 Q and concludes with comments on how the DPP regime as a whole can be improved.

Timing of price-quality path

7. MEUG notes the regulatory period for RCP2 will be 5 years consistent with s. 53M (4).

Price content of price-quality path per s 53 M (1)

8. MEUG comments on forecasting components used to derive the price path are set out in our separate submission on the "Low cost forecasting approaches for Default Price-Quality Paths" paper. That submission notes the prohibition of comparative benchmarking on efficiency will lead to less efficient outcomes and higher prices paid by consumers than would otherwise occur.

9. Table X3 (px5) lists the value over Regulatory Control Period 2 (RCP2) of the proposed deferred claw-back and balance of adjustments for prior limits on price increases for Alpine, Top Energy, Centralines and Unison. In paragraph X18 the paper states "We invite submission on whether these amounts should be applied in full in the next regulatory period. The alternative would be to smooth the recovery over a longer timeframe, eg, over two regulatory periods. Such an approach may help minimise price shocks to consumers." If the average, upper and lower range of rate and absolute dollar amount per year per consumer increase is material then MEUG agrees spreading these allowances over RCP2 and RCP3 should be considered. MEUG notes that inclusion of these allowances does not infer the EDB have to charge to recover the allowances. EDB can charge at any level as long as they are below the price path. Further MEUG does not believe there is any reason if, for example, the Commission were not to give these allowances at all that that would have any bearing on incentives to invest and innovate by these EDB in the future.

10. Paragraph 5.2 and footnote 40 of the paper invites views on the materiality of pass-through and recoverable costs following Genesis Energy's cross-submission on the prior process and issues paper consultation round. MEUG agrees with the position of Genesis Energy. MEUG's view that EDB should be exposed to pass-through costs has been a long-standing argument. In the Commission's IM Reasons Paper, 22nd December 2010 paragraph 8.3.32 and 8.3.33 stated:

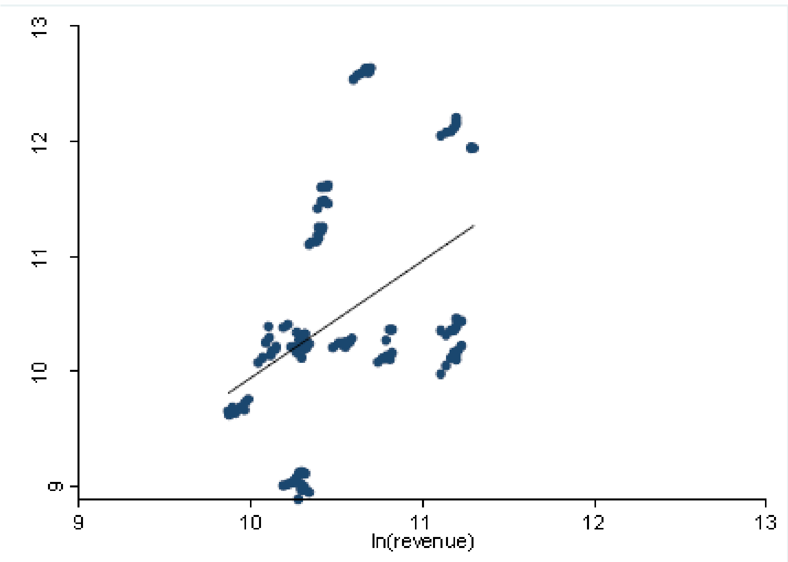
> "Suppliers supported the inclusion of the pass-through costs listed above. However, MEUG did not agree that rates or levies should be included as pass-through costs because they are not entirely outside the control, of the supplier (as the supplier can and should make submissions to rating authorities), are relatively small and there would be benefits in simplifying the calculation and reporting.

> The Commission has decided that it is appropriate for such rates and levies to be passed through to consumers, because these costs may be material and are reasonably incurred in the supply of regulated services. In addition, as EDBs and GPBs are not the only ratepayers, their specific ability to control or influence these costs is limited."

MEUG note that EDB and GPB are substantial enterprises with expertise in asset management planning and charging for infrastructure assets and therefore are better placed than most other ratepayers to contribute positively in discussions with local authorities on rates. Likewise the levies set by the Commission and Electricity Authority can be influenced by knowledgeable parties, of which EDBs have superior knowledge than any other party in relation to distribution networks.

11. MEUG is not convinced inclusion of an IRIS mechanism in DPP regulation is appropriate. The Commission's IM (Electricity Distribution and Gas Pipeline Services) Reasons paper, December 2010 stated (paragraph 8.5.6) "A rolling incentive scheme is contingent on having reliable cost forecasts for the regulatory period. This is required to make it possible for the regulator to assess and reward the extent of any unforecast efficiency gains achieved by the suppliers". Later in paragraph 8.5.11 of the December 2010 IM Reasons paper the Commission said "Due to the required characteristics for implementing a rolling incentive scheme (discussed in paragraph 8.5.6 above), such a mechanism is not suitable for suppliers under a DPP." MEUG suggests there is still sufficient uncertainty and unreliability for individual EDB cost forecasts under DPP to undermine the valid use of IRIS for DPP. By valid we mean proper and fair to consumers and all EDB. The uncertainty of cost forecasts is illustrated in figure C1 of the "Low cost forecasting approaches for Default Price-Quality Paths" paper comparing the low cost model for forecasting non-network operating expenditure with actual date between 2004 and 2012 below:

Figure C1: Predictive power of our non-network operating expenditure model



12. This graph we suggest give sufficient doubt as to the accuracy of the proposed forecast costs to warrant withdrawing the application of IRIS to DPP.

Quality content of price-quality path per s 53M (1) (b), (2) and (3)

13. The introduction of mechanisms to link revenue to network reliability and to do so in a limited way (ie 1% of "revenue at risk") is welcomed. The devil though is in the detail. Unlike Transpower's IPP where the Commission can better understand and tailor such a scheme; with the DPP regime the forecast cost and quality data is less reliable. That lack of precision on the optimal price and quality pairing for each EDB is accentuated by the legislative prohibition on the Commission using comparative benchmarking for efficiency. With these factors in mind MEUG suggest the following changes to the incentive scheme:

    a) The SAIDI targets in table 6.1 (p36) and SAIFI targets in table 6.2 (p37) be treated as "optimal" given the associated price path with adjustments suggested by MEUG in this submission and "Low cost forecasting approaches for Default Price-Quality Paths" submission.

    b) We agree with the collar and penalty rates for under-performance relative to the quality targets.

    c) Quality achieved above target has diminished utility to consumers and therefore we see no reason to pay an incentive rate to EDB to over-perform. Accordingly MEUG submits the SAIDI cap and SAIFI cap listed in tables 6.1 and 6.2 should be the same as the quality targets.

14. The SAIDI and SAIFI targets are enterprise wide. Individual consumers are more concerned about actual unplanned and planned outages that affect their household or business; not EDB enterprise wide targets. Transpower has recognised this in its IPP by having different quality targets for different consumer classes. MEUG notes that DPP may serve monopoly suppliers as a low cost regulatory regime but it fails to allow differentiation of quality by different customer classes. This would be a useful topic of research to improve Part 4 regulation in the future. This work would be in addition to research on the useful list of other aspects of quality that consumers' value in paragraph 6.35 of the paper.

Energy Efficiency (S 54 Q)

15. The energy efficiency proposals with the new D-Factor are, at this stage, reasonable except for discretion given to the Commission to approve or not (paragraph E16). MEUG suggests either EDB must consult before making an application for approval to the Commission or the Commission must on receipt of an application consult with interested parties.

16. MEUG supports incentives for innovation in Part 4 as a whole including those for s.54Q. However innovation should only reward those that take the risk and are successful with an innovation first. That is a first mover advantage that spurs innovation. Not all EDB should benefit in terms of a higher return above regulated WACC simply because they copy an innovation by another EDB. In markets late comers to adopting an innovation will earn below the industry WACC. The regulatory regime needs to mimic this outcome.

17. From observed behaviour of smaller EDB MEUG believes that only the largest EDB will have the expertise and resources to seek approval of a D-factor. This leads to the broader policy question of whether implementing the new D-Factor proposal undermines other outcomes sought from an effective Part 4 regime such as more EDB applying for CPP. If the D-factor and proposed IRIS mechanism for DPP (discussed in paragraph 11 above) in effect becomes a CPP "lite" option without the checks and balances of a CPP where the Commission can consider the specific circumstances of an individual EDB; then this will be a poor outcome. MEUG is not convinced an IRIS mechanism can be added to the DPP regime but we are still open to the D-factor proposal for energy efficiency innovation provided it applies for only for first mover advantage interested parties are consulted by the applicant or the Commission.

Suggestions for more effective price-quality path regulation

18. In the future DPP and Part 4 regulation is likely to be improved by:

    a) Removing the legislative prohibition on benchmarking;

    b) Keeping DPP as low cost and vanilla as possible with a measure of success being more EDB applying for CPP. The fact only Orion has applied for a CPP may reflect a benign regulatory environment with the current DPP settings. Incremental changes to DPP need to apply more pressure for improved productivity and not become a CPP "lite" option favouring EDB;

    c) Considering the other aspects of quality valued by consumers listed in paragraph 6.35 of the paper and having different quality targets for different consumer classes as discussed in paragraph 14 above.

    d) The Commission has not used the option of prescribed compensation for minimum performance standards (as allowed under s 53 M (2) (c)) and perhaps this should be the direction to head for RCP3.

Next steps

19. We look forward to viewing the submissions of other parties on the DPP Main Policy paper and making cross-submissions as required.

Yours sincerely

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