

**COMMERCE COMMISSION**

**Regulation of Electricity Lines Businesses**

**Targeted Control Regime**

**Draft Decision: Reasons for Not Declaring Control**

**Unison Networks Limited**

**9 November 2006**

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## EXECUTIVE SUMMARY

The Commerce Commission has received an administrative settlement offer from Unison Networks Limited (Unison) that includes undertakings concerning Unison's future performance. Unison's offer 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 Part 4A of the Commerce Act 1986 (the Act).

The purpose of this paper is to present the Commission's reasons for its draft decision that Unison's administrative settlement offer—considered in the context of the Commission's earlier intention to declare control—should be accepted, and to invite interested persons to give their views on that draft decision.

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 is being publicly released along with this paper.

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.

More significantly however, businesses have an incentive to outperform the efficiency expectations implied by their price path threshold, thereby increasing the level of benefits that are potentially available to be shared with consumers from the *end* of the regulatory period (i.e., after 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 price path.

The Commission considers that, in complying with its existing price path threshold and the other terms of the administrative settlement, Unison's performance during the settlement period would be consistent with the objectives of the targeted control regime. In the Commission's view, Unison's existing price path threshold provides 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 threshold. Given that Unison has now agreed to move its performance back within the threshold and to resolve the other performance concerns identified by the Commission, it is appropriate for Unison's existing price path threshold to be retained. 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***

The Commission considers that the following net benefits to consumers would be realised from accepting and implementing Unison's Revised Offer:

- Unison's voluntary compliance with its existing thresholds, and its commitment to addressing the performance issues identified in the Commission's intention to declare control, would ensure behaviour consistent with the regime's objectives at a lower administrative and compliance cost than control;
- in particular, Unison's incentives to invest to maintain network performance would 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 would 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 from the end of that period;
- positive impacts on investment incentives for the wider industry would likely stem from the regulatory stability signals provided by the Commission in reinforcing its commitment to a medium-term price path;
- with any voluntary settlement there is a possibility of non-compliance, but the Commission considers it would be relatively straightforward to monitor the implementation of the settlement; and
- Unison's asset management plans, capital and maintenance expenditure, and its reliability performance, would also be subjected to regular reviews by the Commission.

## **Background to Unison's Settlement Offer**

### ***Targeted control regime***

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, control is "targeted" rather than universal, because 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.

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 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.

A breach of the thresholds enables the Commission to investigate the 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***

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—likely referring to the terms of the settlement.

### ***Unison Networks Limited***

Unison is the fourth largest distribution business in New Zealand, measured by 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***

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.

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%.

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.

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***

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.

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.

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***

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.

Following subsequent dialogue between the Commission and Unison, on 1 September 2006 Unison provided the Commission with its revised administrative settlement offer, 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***

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 its existing price path threshold as at 31 March 2007, had those tariffs 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 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***

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.

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 of 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 will result in a further reduction of \$14/ICP on average in Rotorua/Taupo, and \$1/ICP on average in Hawke's Bay.

The Commission notes that the average reductions from the price changes already made by Unison, combined with the changes planned 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
- what might be an acceptable revenue path as part of a settlement cannot be seen as a proxy for the revenue which the Commission might subsequently allow under control, if a settlement cannot be agreed upon—however, while the Commission might seek to

share past efficiency gains with consumers sooner under control than under a settlement, incentives for future efficiency gains would still need to be built into any control mechanism.

Unison proposes retaining 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 will face increases, whereas other groups will receive reductions significantly greater than the average (as is shown in the table below). For example, the most significant price reduction is proposed for large commercial consumers in Rotorua/Taupo (i.e., down \$7,563 for the current year, or 36.8%). All the rebalancing changes are 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 will be implemented by Unison in two stages, with the second stage being on 1 April 2007.

#### **Estimated Average Tariff Changes \***

| <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 in the *distribution* component of allocated revenue (i.e., excluding transmission charges)

The Commission considers that, on the face of it, the principles and assumptions underpinning Unison's new Cost of Supply model are not unreasonable, but should be tested through consultation with interested parties. Hence, the Commission seeks the views of interested parties on Unison's Cost of Supply model, as well as on Unison's specific proposals for tariff changes on 1 December 2006.

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

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.

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.

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.

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) has been publicly released with this paper.

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.

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. 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***

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.

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.

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.

The Commission's preliminary view is to accept 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.

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

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, the Commission's current view is that control is *not* necessary to address the concerns identified in the Intention Paper (which are summarised above), because these concerns would be appropriately addressed through acceptance and implementation of the Revised Offer.

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

While control would limit Unison's ability to extract excessive profits, Unison's voluntary compliance with its existing price path threshold would, 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 would be preserved over the settlement period, because the company would 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 would ensure that Unison is accountable for making its planned investments.

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

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 would result in further price reductions for all consumers, on average.

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 from the end of the regulatory period. 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***

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 would 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***

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 its preliminary view is that no further action is necessary. 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 preliminary view***

In conclusion therefore, the Commission's preliminary view is that the likely 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 would 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 regime are achieved, provided the settlement is implemented.

### ***Next steps and possible outcomes of the post-breach inquiry***

After having regard to the views of interested parties, which will include the information from submissions and cross-submissions on this paper, the Commission will make a final decision on whether to accept Unison's Revised Offer. (A timetable of next steps is provided in Table 5 on page 61 of this paper).

If the Commission's preliminary view set out in this paper is confirmed, and Unison's Revised Offer is accepted, then the Commission would be able to close its post-breach inquiry into all of Unison's past threshold breaches. Subsequently, the Commission would publish its reasons for not making a control declaration in the *Gazette*.

If, after taking into account the views of interested parties, the Commission does not accept Unison's offer, then the Commission would still need to decide whether or not to declare control. At that stage, the Commission may also undertake another round of consultation to seek the views of interested parties if the Commission considers that control may still be warranted.

## INTRODUCTION

### Purpose and Scope

- 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>1</sup> Unison is a distribution business that supplies electricity distribution services to consumers in the Hawke's Bay, Rotorua and Taupo regions.
- 2 Since publishing that intention and its reasons for forming that intention,<sup>2</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 undertakings concerning Unison's performance for the period until 31 March 2009.<sup>3</sup>
- 3 The purpose of this paper is to set out the Commission's draft decision that Unison's administrative settlement offer—considered in the context of the Commission's earlier intention to declare control—should be accepted, and to invite interested persons to give their views on that draft decision.
- 4 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).
- 5 Under subpart 1 of Part 4A (ss 57D to 57N of the Act), the Commission must set thresholds for the declaration of control of goods or 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.
- 6 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 goods or 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 business breaching the thresholds, the Commission may conduct a “post-breach inquiry”.
- 7 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,

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<sup>1</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>2</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Intention to Declare Control, Unison Networks Limited*, 9 September 2005.

<sup>3</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.

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.

- 8 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.
- 9 As noted above, the Commission's preliminary view is to accept Unison's offer. If this preliminary view is confirmed and Unison's offer is accepted, then the Commission would be able to close its post-breach inquiry into all of Unison's past threshold breaches. Subsequently, in accordance with s57H(d)(ii) of the Act, the Commission would need to publish its reasons for not making a control declaration in the *Gazette*.
- 10 If, after taking into account the views of interested parties, the Commission does not accept Unison's offer, then the Commission would still need to decide whether or not to declare control.
- 11 This paper presents the Commission's draft reasons for not making a control declaration in respect of Unison's distribution services. In sum, these are because, 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 can be achieved without a declaration of control being made, provided the settlement is implemented.
- 12 Release of this paper represents the first occasion that this step of the regulatory process has been reached (i.e., consultation on an administrative settlement offer). As such, this paper outlines the Commission's framework for assessing whether an administrative settlement offer should be accepted. A copy of Unison's settlement offer is also released with this paper (along with the Commission's review of Unison's 2006 asset management plan).<sup>4</sup>
- 13 This paper is structured as is shown 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>  |
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<sup>4</sup> PBA, *Review of 2006 Asset Management Plan, Unison Networks Ltd*, Prepared for Commerce Commission, October 2006.

| Section Heading                                     | Content  |
|---|--|
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| Draft Decision Not to Declare Control of Unison     | <ul style="list-style-type: none"> <li>▪ Commission's preliminary acceptance of Unison's Revised Offer</li> <li>▪ Next steps</li> <li>▪ Possible outcomes of the post-breach inquiry</li> </ul>  |

## Statutory Framework and Process

### *Targeted control regime*

- 14 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.

- 15 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 goods or 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 goods or services supplied by a lines business for which a declaration of control has been made by the Commission.

- 16 Control is *targeted*, in the sense that it is not universal, by virtue of the processes set out in subpart 1 of Part 4A. 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 39).

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

- 17 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.
- 18 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).
- 19 For a distribution business, the price path threshold therefore 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.
- 20 The price path threshold is conceptually similar to the various forms of CPI-X price control that regulators commonly use in overseas jurisdictions. While the price path threshold is not an instrument of control, it is similarly designed to be an incentive mechanism. 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.

### ***Quality threshold***

- 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>5</sup> and

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<sup>5</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.

- *consumer engagement (or customer communication) criteria*, requiring meaningful engagement with consumers to determine their demand for service quality.
- 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.

### ***Initial thresholds***

- 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>6</sup> and were explained in a decisions paper published on the same day.<sup>7</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).
- 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***

- 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* are of the same form as the thresholds set by the Commission on 6 June 2003. However, for the price path 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.
- 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,

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

<sup>7</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime: Thresholds Decisions*, 6 June 2003.

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).

- 27 The reset thresholds for distribution businesses were set by a notice in the *Gazette* (Distribution Thresholds Notice),<sup>8</sup> and explained in an accompanying decisions paper.<sup>9</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***

- 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.
- 29 First, all distribution businesses face an X factor which partly reflects expected industry-wide improvements in efficiency (paragraph 26). Therefore, there will be some sharing of efficiency gains with consumers *during* the five-year regulatory period.
- 30 Second, and more significantly, businesses have an incentive to outperform the efficiency expectations implied by their price path threshold (paragraph 20), thereby increasing the level of benefits that are potentially available to be shared with their consumers from the *end* of the regulatory period. 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 business to retain this higher level of returns preserves the incentives for that business to make ongoing efficiency gains in subsequent periods.
- 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).
- 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.

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<sup>8</sup> Commerce Act (*Electricity Distribution Thresholds*) Notice 2004, Supplement to *New Zealand Gazette*, Issue No. 37, 31 March 2004.

<sup>9</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime: Thresholds Decisions (Regulatory Period Beginning 2004)*, 1 April 2004.

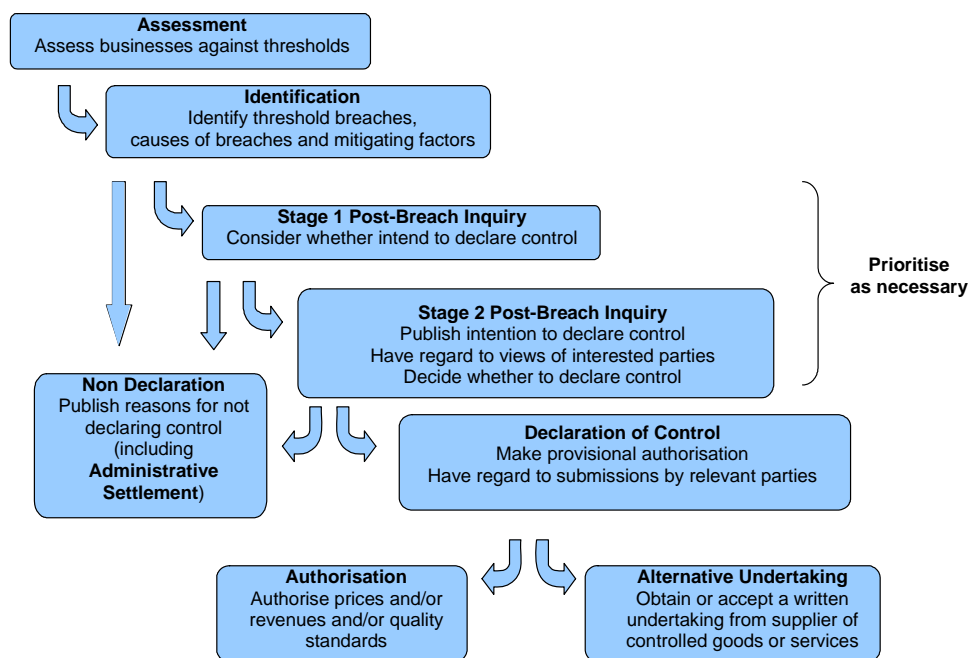
## Assessment and Inquiry Guidelines

- 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>10</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 target 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

- 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.

**Figure 1: Targeted Control Process Steps**



- 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.

<sup>10</sup> Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Assessment and Inquiry Guidelines*, 19 October 2004.

- 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 consistent with 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.
- 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*

- 38 Under s 57H(c) of the Act, the Commission must determine whether or not to declare all or any of the goods or 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”.
- 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.
- 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*

- 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.

- 42 Section 57M(1) provides that in exercising its powers under sections 70 to 72 concerning goods and 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.
- 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.
- 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.
- 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***

- 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.
- 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.
- 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>11</sup>

### ***Administrative settlements***

- 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 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

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<sup>11</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.

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.

- 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.
- 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 likely refer to the terms and conditions of the administrative settlement.

### ***Government Policy Statement (GPS)***

- 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.

- 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 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'."

- 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."

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.

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 draft decisions outlined in this paper.

## BACKGROUND TO UNISON'S SETTLEMENT OFFER

### Unison Networks Limited

#### *Overview of the company*

- 57 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>12</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").
- 58 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.
- 59 The company remains, however, 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. Consequently, consumers in the Rotorua /Taupo region are not beneficiaries of any distributions that might be made to the HBPCT.
- 60 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*

- 61 Under the initial CPI-X price path threshold (paragraphs 17-0), 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).
- 62 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 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 its performance

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<sup>12</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.

from 1 April 1999 to 31 March 2002—in other words, prior to the company’s acquisition of the Rotorua and Taupo networks.<sup>13</sup>

- 63 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*

- 64 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.
- 65 Unison breached the price path threshold at the first assessment date by \$1.8 million (or 4.0% of notional revenue),<sup>14</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>15</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>16</sup>
- 66 Unison breached the price path threshold at the second assessment date as a result of further price increases on 1 March 2004.<sup>17</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>18</sup> The magnitude of this second breach was \$11.0 million (or 23.9% of notional revenue).
- 67 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>19</sup> As with the

<sup>13</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 9, p 59; and Meyrick and Associates, *Regulation of Electricity Lines Businesses, Analysis of Lines Business Performance – 1996-2003*, 19 December 2003, p 61.

<sup>14</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>15</sup> Unison, *Threshold Compliance Statement for the First Assessment Date*, 17 October 2003.

<sup>16</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>17</sup> Unison, *Threshold Compliance Statement for the Second Assessment Date, 31 March 2004*, 20 May 2004.

<sup>18</sup> Unison, *Pricing Review 2004, Pricing Impact Analysis*, Prepared for Board of Directors, December 2003, pp 1, 4 and 5.

<sup>19</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.

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***

- 68 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***

- 69 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.
- 70 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>20</sup> Unison had presented similar arguments during the consultation process on resetting the price path threshold.
- 71 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>21</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.
- 72 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

<sup>20</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>21</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.

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*

- 73 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.
- 74 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.
- 75 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>22</sup>
- 76 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.
- 77 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 73), given that:
- 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.

<sup>22</sup> Unison, *Pricing Strategic Plan*, 11 September 2003, pp 7 and 23.

- 78 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.

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

- 79 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>23</sup>
- 80 A rate of return target of 9.42% was well in excess of the Commission's indicative range for the WACC.<sup>24</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**

- 81 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. 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.
- 82 Part of the information sought from Unison was disaggregated data relating to each of the company's three 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. The Commission does not have a concern with a distribution business earning a reasonable return on behalf of its consumer owners or beneficiaries, but the Commission would be concerned if it were to find that pricing and/or investment decisions are weighted inappropriately in favour of those owners or beneficiaries, to the detriment of the other consumers supplied by the business.
- 83 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, capital contributions, asset valuations, capital expenditure, direct and indirect costs, tax expenditure, depreciation, interest expenditure and system statistics;
  - associated business policies;

<sup>23</sup> Unison, *Revenue Requirement Calculation for Unison*, 17 November 2003.

<sup>24</sup> Commerce Commission, *supra* n 10, August 2003, pp 38-39.

- 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**

- 84 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.
- 85 In response, Unison informed the Commission that it intended making an administrative settlement offer to the Commission by the end of February 2005 (paragraphs 49-51). Unison also advised that it intended suspending its planned price increases (scheduled for 1 April 2005), pending the outcome of the Commission's investigations.
- 86 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.
- 87 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 80), 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**

- 88 In May 2004 Unison filed an application in the High Court for a review of the Commission's decisions concerning the 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>25</sup> Unison appealed the High Court judgment, which the Court of Appeal subsequently upheld.<sup>26</sup>

- 89 The substantive proceedings were heard by the High Court in October 2005, and the judgment was issued on 28 November 2005.<sup>27</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. Unison subsequently appealed the High Court's findings in respect of the legality of the thresholds (but not in respect of the post-breach inquiry process), and the Court of Appeal heard the case in July 2006. The Court of Appeal judgment for the substantive proceedings is still pending.

## **Decision to Publish an Intention to Declare Control**

### ***Intention to declare control***

- 90 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>28</sup>
- 91 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>29</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>30</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.
- 92 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***

- 93 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

<sup>25</sup> *Unison Networks Limited v The Commerce Commission*, unreported judgment of MacKenzie J, CIV-2004-485-960, 29 July 2005.

<sup>26</sup> *Unison Networks Limited v The Commerce Commission and Anor*, Court of Appeal, CA161/05, 24 August 2005.

<sup>27</sup> *Unison Networks Limited v The Commission & Powerco Limited*, unreported judgment of Justice Wild, CIV 2004 485 960, 28 November 2005.

<sup>28</sup> Commerce Commission, *supra* n 1.

<sup>29</sup> Commerce Commission, *supra* n 2.

<sup>30</sup> Lally, M., *The Weighted Average Cost of Capital for Electricity Lines Businesses*, 8 September 2005.

quality standards of the controlled services supplied by a lines business subject to control.

- 94 Drawing on the Commission’s Guidelines (paragraph 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>31</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; and
  - aim for allocatively efficient price levels, commensurate with the level of service quality consumers demand and based on productively/dynamically efficient costs.<sup>32</sup>
- 95 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>33</sup>
- 96 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 (paragraph 0), were described as being more difficult to quantify.<sup>34</sup>
- 97 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>35</sup>

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

- 98 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>36</sup>

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<sup>31</sup> Commerce Commission, *supra* n 2, paragraphs 77-83.

<sup>32</sup> *ibid*, paragraphs 95-97.

<sup>33</sup> *ibid*, paragraphs 101-103.

<sup>34</sup> *ibid*, paragraphs 111-112.

<sup>35</sup> *ibid*, paragraphs 91-94.

<sup>36</sup> *ibid*, paragraphs 116-117.

- 99 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;
  - *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>37</sup>
- 100 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 below.

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

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

- 101 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).
- *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 79). The Commission constructed a corresponding factual revenue path using Unison’s

<sup>37</sup> *ibid*, paragraphs 118-122.

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 87). 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 a result, the factual revenue path for Scenario 2 was higher than that for Scenario 1, despite the counterfactual revenue path being lower.<sup>38</sup>

102 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>39</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.

103 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>40</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>41</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>42</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>43</sup>

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<sup>38</sup> *ibid*, paragraphs 224-240.

<sup>39</sup> *ibid*, paragraph 257.

<sup>40</sup> *ibid*, paragraphs 200-218.

<sup>41</sup> *ibid*, paragraphs 234-245.

<sup>42</sup> *ibid*, paragraphs 219-223.

<sup>43</sup> *ibid*, paragraphs 260-270.

- 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>44</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>45</sup>

### ***Consultation process on the Intention Paper***

- 104 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 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 14-15 December 2005.
- 105 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.
- 106 Following the conference, thirteen cross-submissions were received. Copies of all submissions and cross-submissions can be obtained the Commission's website: [www.comcom.govt.nz](http://www.comcom.govt.nz). In the draft 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).

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

- 107 On 1 April 2006, Unison reversed its March 2004 distribution price rises in Rotorua and Taupo (paragraph 66). 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>46</sup>

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<sup>44</sup> *ibid*, paragraphs 246-259.

<sup>45</sup> *ibid*, paragraph 271.

<sup>46</sup> Commerce Commission, *Unison to reverse electricity price rises for Rotorua, Taupo*, Media Release, 17 March 2006.

*Revised settlement offer of September 2006*

- 108 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 71).
- 109 Following subsequent discussions between the Commission and Unison, on 1 September 2006,<sup>47</sup> Unison provided the Commission with its final revised administrative settlement offer (dated 30 August 2006), for a settlement period ending on 31 March 2009.<sup>48</sup> The offer outlines 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 63) 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.
- 110 In addition, Unison's offer indicates that, on a regional basis, the tariff changes over the settlement period will reflect cost allocations between the regions that result in a consistent rate of return from each regional network. Furthermore, Unison will 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.
- 111 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>49</sup> Unison explained that retailers had confirmed they understand the circumstances in which Unison is proposing a tariff change beyond the normal annual cycle and therefore Unison will 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 involve a mix of individual tariff increases and decreases. Instead, the earliest date that the retailers can agree on to implement the change is 1 December 2006.
- 112 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>50</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 30 August document, as amended by its letters of 13 September and 18 October 2006, is subsequently termed the Revised Offer).

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<sup>47</sup> Unison, *Unison's Settlement Proposal*, Letter from Brian Martin to Paula Rebstock, 1 September 2006.

<sup>48</sup> Unison, *supra* n 3, 30 August 2006.

<sup>49</sup> Unison, *supra* n 3, 13 September 2006.

<sup>50</sup> Unison, *supra* n 3, 18 October 2006.

***Commission's preliminary view regarding the Revised Offer***

- 113 The Commission has reviewed Unison's Revised Offer and has 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 can be achieved without a declaration of control needing to be made, provided the settlement is implemented. Moreover, in the Commission's view, the Revised Offer forms a suitable basis for consultation with interested parties (and it is therefore being released with this paper).
- 114 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, and provide the Commission's preliminary 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.

## FRAMEWORK FOR EVALUATING ADMINISTRATIVE SETTLEMENTS

- 115 This section sets out the analytical framework that the Commission has used for evaluating Unison’s most recent administrative settlement offer—the Revised Offer. This framework forms the basis for the Commission’s preliminary view that it ought to accept Unison’s Revised Offer and decide not to declare control.
- 116 The Commission welcomes views from interested parties on the evaluation framework that has been applied.

### Basis for Not Declaring Control

#### *Statutory interpretation*

- 117 As described above (paragraph 93), in determining whether or not to declare control, the Commission must have regard to the overall purpose of the targeted control regime—namely, to promote the efficient operation of electricity transmission and distribution markets for the long-term benefit of consumers (paragraph 14).
- 118 In *Unison Networks Limited v the Commission & Powerco Limited* (described above in paragraphs 88-89), Justice Wild 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>51</sup>
- 119 His Honour 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”.
- 120 His Honour 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.
  - (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.

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<sup>51</sup> supra n 27.

- 121 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. Justice Wild observed that each of these three steps allows the Commission to achieve the “purposes” of Part 4A. Justice Wild 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: ss 57H.
  - c) Step 3: process for deciding whether or not to declare price control: ss 57H and 57I.
- 122 A breach of the threshold gives the Commission a basis on which to investigate the circumstances specific to the business concerned. Accordingly, the Commission is of the view that its basis for declaring control may be unrelated to the specific cause of the breach. That the Commission's inquiry may be wider than the breach is reinforced by Justice Wild's judgment. In identifying a number of key features of the targeted control regime, His Honour 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 an 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.

- 123 On the other hand, His Honour 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.

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.

### ***Role and process for administrative settlements***

- 124 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 that 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.
- 125 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).

- 126 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**

- 127 As described above (paragraph 97), 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.
- 128 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.
- 129 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>52</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 factuials and counterfactuals that has already been undertaken, without necessarily having to redo a full updated building blocks analysis.
- 130 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 99), 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.

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<sup>52</sup> Commerce Commission, *supra* n 2, paragraphs 100, 105-108 and 246.

## Net Benefits of Accepting and Implementing a Settlement Offer

### *Net benefits of control*

- 131 As discussed above (paragraphs 95-96), 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*

- 132 While the same general types of benefits and costs are likely to be relevant to the implementation of an administrative settlement, a settlement differs markedly from control because it is a voluntary action 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.
- 133 Because a settlement is a voluntary arrangement, direct compliance and administrative costs are likely to be lower than under control (particularly given mitigated litigation risk), and the arrangement is likely to 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. However, other factors to consider are whether there is any possible 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 recommence the process in s 57H for making a decision on a declaration of control in relation to that business.

### *Efficiency implications*

- 134 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 52-55). 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).
- 135 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 28).

- 136 As discussed above (paragraphs 29-31), 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.
- 137 As a result, consumers will benefit more because the level of efficiency gains available to be shared over subsequent regulatory periods—after 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.
- 138 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) could dampen 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.

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

- 139 In addition, 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***

- 140 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 any excessive profits may be shared with consumers earlier. 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.

- 141 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.

***Summary of potential net benefits***

- 142 In sum, the Commission considers the following issues are likely to be 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 greater benefits available to be shared with consumers from the end of the regulatory period as a result of maintaining regulatory commitment to a medium-term price path, as long the business concerned 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 with the settlement terms.

## EVALUATION OF UNISON'S SETTLEMENT OFFER

- 143 This section presents the key elements of Unison's administrative settlement offer of 30 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

- 144 As described above (paragraphs 109-110), the main thrust of Unison's Revised Offer is that the company will 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 reflect the costs of supplying them.
- 145 The Revised Offer has the qualification that it is made without prejudice to Unison's position in respect of the ongoing post-breach inquiry, and is subject to the outcome of the Court of Appeal proceedings relating to Unison's judicial review application of the threshold decisions (paragraphs 88-89). The Commission acknowledges this qualification.
- 146 Unison also notes in the Revised Offer that, in the event of a material change in the "regulatory landscape", the company may seek an amendment to any terms agreed with the Commission as part of the settlement. Unison indicates its understanding that such an approach would need to be supported by relevant evidence of the change and its likely impact.<sup>53</sup> The Commission considers that it is not necessary to explicitly provide for such circumstances in the terms of the settlement, and agrees that, if Unison were to consider that circumstances have materially changed, the company would always have an opportunity to raise these with the Commission.
- 147 Unison also reiterates a number of reservations that it generally has concerning the targeted control regime in Part 4A.<sup>54</sup> The Commission notes that these issues relate to the industry as a whole and not just to Unison, and therefore, where appropriate, the Commission would be seeking the views of interested parties (including Unison) on such issues in the context of other work, such as the review of the information disclosure regime and the reset of the thresholds from 2009.

### Aggregate Pricing Proposals

- 148 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>55</sup> The

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<sup>53</sup> Unison, supra n 3, 30 August 2006, p 1.

<sup>54</sup> *ibid*, p 1.

<sup>55</sup> *ibid*, pp 5-6.

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.

- 149 Unison estimates that, irrespective of the tariff changes on 1 December 2006, it 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>56</sup>
- 150 The Commission agrees that Unison will be unable to avoid breaching the "secondary" price path threshold, despite its planned average price reductions from 1 December 2006.<sup>57</sup> The Commission considers that, if—following consultation—it is confirmed that acceptance of Unison's settlement would be 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 relatively straightforward to determine whether such is the case.

## Disaggregated Pricing Proposals

### *Pricing principles*

- 151 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 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 will rebalance 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>58</sup>
- 152 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>59</sup> and include:

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<sup>56</sup> *ibid*, p 9.

<sup>57</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.

<sup>58</sup> *ibid*, pp 10-11.

<sup>59</sup> Pricing Approaches Working Group, *Model Approaches to Distribution Pricing*, 2 February 2005. PAWG has been funded by 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 or model approaches to distribution pricing (Government Policy Statement in Relation to Electricity Industry Governance, October 2006, paragraph 98).

- 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>60</sup>

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

- 153 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 is currently the case. Unison's reasons are that:
- Unison's development plans include strengthening of the contiguity of the two network areas;
  - 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;
  - it would reflect the common reliance on Siemens' outsourced services in the two network areas; and
  - 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>61</sup>
- 154 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>62</sup>

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<sup>60</sup> Unison, supra n 3, 30 August 2006, pp 21-22.

<sup>61</sup> *ibid*, p 10.

<sup>62</sup> *ibid*, pp 22-43.

- 155 Unison notes that the reduction in charges to Taupo and Rotorua consumers implemented from 1 April 2006 (paragraph 107) 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 will result 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>63</sup>
- 156 The Commission notes that the average reductions from the price changes already made by Unison on 1 April 2006, combined with the changes planned as part of the Revised Offer, are not as sizeable as the potential price impacts of control presented in the Intention Paper.<sup>64</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>65</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 172 and 180); and
  - what might be an acceptable revenue path as part of a settlement cannot be seen as a proxy for the revenue which the Commission might subsequently allow under control, if a settlement cannot be agreed upon (paragraph 140)—however, while the Commission might seek to share past efficiency gains with consumers sooner under control than under a settlement, incentives for future efficiency gains would still need to be built into any control mechanism (paragraph 30).

### *Customer group pricing assumptions and impacts*

- 157 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.
- 158 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.
- 159 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

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<sup>63</sup> *ibid*, p 12.

<sup>64</sup> Commerce Commission, *supra* n 2, paragraph 271.

<sup>65</sup> Commerce Commission, *Commerce Commission Conference on the Intention to Declare Control of Unison Networks, Transcript*, 6 December 2005, pp 143-144.

(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.

- 160 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.
- 161 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**

| 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>66</sup>

† % change in *distribution* component of allocated revenue (i.e., excluding transmission charges)

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

| Customer Group   | Rotorua/Taupo | Hawke's Bay | Total Unison |
|------------------|---------------|-------------|--------------|
| 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%         |

- 162 These values are not the percentage change in ROI, but the estimated absolute difference between the current ROI (in percent) and Unison's target ROI (in percent) for each customer group when determined consistently on Unison's basis (for cost

<sup>66</sup> Unison, supra n 3, 30 August 2006, pp 10-14 and 23-46.

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 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>67</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.

- 163 The Commission notes that the Revised Offer does not indicate the extent of the necessary rebalancing it intends addressing at each of the 1 December 2006, 1 April 2007 and 1 April 2008 dates. However, the Commission has since confirmed with Unison that all the rebalancing changes are 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. Given the concerns from some retailers as to a 1 December 2006 rebalancing date, decreases to the Rotorua/Taupo large commercial customer group will be implemented by Unison in two unequal stages, with the second stage being on 1 April 2007, and increases to Rotorua/Taupo mass market customers will be deferred until 1 April 2007.<sup>68</sup> The Commission considers this staged proposal is a pragmatic response to retailers' concerns given that the two tariff change dates are only a few months apart.
- 164 Overall, the Commission considers that, on the face of it, the principles and assumptions underpinning Unison's new Cost of Supply model are not unreasonable, but should be tested through consultation with interested parties. Hence, the Commission seeks the views of interested parties on Unison's Cost of Supply model, as well as on Unison's specific proposals for tariff changes on 1 December 2006 and 1 April 2007. To assist the consultation process the Commission has requested that Unison provide a small amount of additional material in respect of its pricing methodology, in order to improve clarity and transparency.

## Investment Proposals

### *Capital expenditure targets*

- 165 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

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<sup>67</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 , paragraphs 200-218).

<sup>68</sup> Unison, *supra* n 3, 18 October 2006.

broken down into four components: customer-driven network extension; network capacity and security augmentation; asset renewals; and underground conversion expenditure.<sup>69</sup> A discussion of Unison's asset management approach and practices are presented in Appendix B of its Revised Offer.<sup>70</sup>

- 166 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>71</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>72</sup>

- 167 Unison commits to reporting annually, in its subsequent AMPs, on the cumulative renewals spend against the forecast included within the settlement proposal.<sup>73</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>74</sup>

- 168 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 contends that "considerable effort has been put into developing these capabilities and Unison intends to continue this development throughout the settlement period."<sup>75</sup>

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

- 169 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 107), the Commission requested PBA to review Unison's investment proposals, maintenance plans and system reliability (discussed further in paragraphs 179-181 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) has been publicly released with this paper.<sup>76</sup>

<sup>69</sup> Unison, supra n 3, 30 August 2006, p 19.

<sup>70</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>71</sup> Unison, *Asset Management Plan*, August 2006.

<sup>72</sup> Unison, supra n 53, p 2.

<sup>73</sup> Unison, supra n 3, 30 August 2006, pp 3 and 19.

<sup>74</sup> *ibid*, p 5.

<sup>75</sup> *ibid*, p 19.

<sup>76</sup> PBA, supra n 4.

- 170 PBA's 2006 AMP Review generally concludes that Unison's 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.<sup>77</sup>
- 171 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>78</sup>
- 172 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>79</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.

**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        |

- 173 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

<sup>77</sup> *ibid*, p 19.

<sup>78</sup> *ibid*, pp 16-17.

<sup>79</sup> As noted above (paragraph 101), the capital expenditure projections used in the Intention Paper were the same in both the counterfactuals and factials of both Scenarios 1 and 2.

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>80</sup>

- 174 PBA accepts Unison's underlying conclusion that asset renewal costs must be significantly increased above historical levels. Nevertheless, PBA considers 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 suggests that the LeverEdge analysis be considered the upper bound of an acceptable range of asset renewal expenditure.<sup>81</sup>
- 175 On the other hand, PBA has also reviewed the top-down methodology used by Unison to forecast its network augmentation requirements and considers 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>82</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).

## Quality Proposals

### *Quality threshold compliance*

- 176 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 68). 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 169). 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>83</sup> Unison supports this position with a report from LECG which is included as Appendix C to the Revised Offer.<sup>84</sup>
- 177 As a result, Unison suggests that it may 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

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<sup>80</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>81</sup> PBA, *supra* n 4, p 14.

<sup>82</sup> *ibid*, p 16.

<sup>83</sup> Unison, *supra* n 3, 30 August 2006, p 15.

<sup>84</sup> *ibid*, Appendix B4: LECG, *Recommended SAIDI & SAIFI Levels for the Quality Thresholds of Unison Networks Ltd*, 29 May 2006.

therefore be discounted when the Commission reviews threshold compliance for the current threshold assessment period.<sup>85</sup>

- 178 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>86</sup>

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

- 179 Given that PBA was already examining related aspects of Unison’s performance as part of its 2006 AMP Review (paragraph 169), 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.
- 180 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>87</sup> 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. PBA concludes 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>88</sup>
- 181 Overall, PBA’s key findings and recommendations with respect to Unison’s system reliability 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

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<sup>85</sup> ibid p 9.

<sup>86</sup> ibid, pp 18 and 20.

<sup>87</sup> PBA, supra n 4, p 12, Table 5.

<sup>88</sup> ibid, pp 12-13.

- 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>89</sup>

182 The Commission’s preliminary view is to accept PBA’s recommendations.

## **Consistency with the Purpose Statement**

### *Unison’s views*

- 183 In 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 Commence Act” and the company discusses each of the elements of s 57E(a)-(c) of the Purpose Statement in turn.
- 184 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.
- 185 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.
- 186 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>90</sup>

### *Commission’s views*

- 187 In general, the Commission considers that a price path threshold—when complemented by a quality threshold—is by its very nature consistent with s 57E(a)-(c) of Part 4A (paragraphs 28-32). 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.
- 188 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 136-138). 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

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<sup>89</sup> *ibid*, pp 19-20.

<sup>90</sup> Unison, *supra* n 3, 30 August 2006, p 20.

ongoing efficiency gains, increases the level of benefits available to be shared with its consumers from the end of the current regulatory period.

- 189 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 103). In fact Unison's offer goes further because it addresses similar disparities between customer groups as well (paragraph 151).
- 190 The Commission considers that, over the regulatory period, Unison's existing price path threshold provides an appropriate level of incentives, and therefore the company did not need to raise its prices further and breach the threshold. Given that Unison has now agreed to move its performance back within the threshold and to resolve the other performance concerns identified by the Commission, it is appropriate for Unison's existing price path threshold to be retained.

## Net Benefits Assessment

### *Relevant factual and counterfactual*

- 191 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.
- 192 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 101), 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>91</sup>
- 193 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.
- 194 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

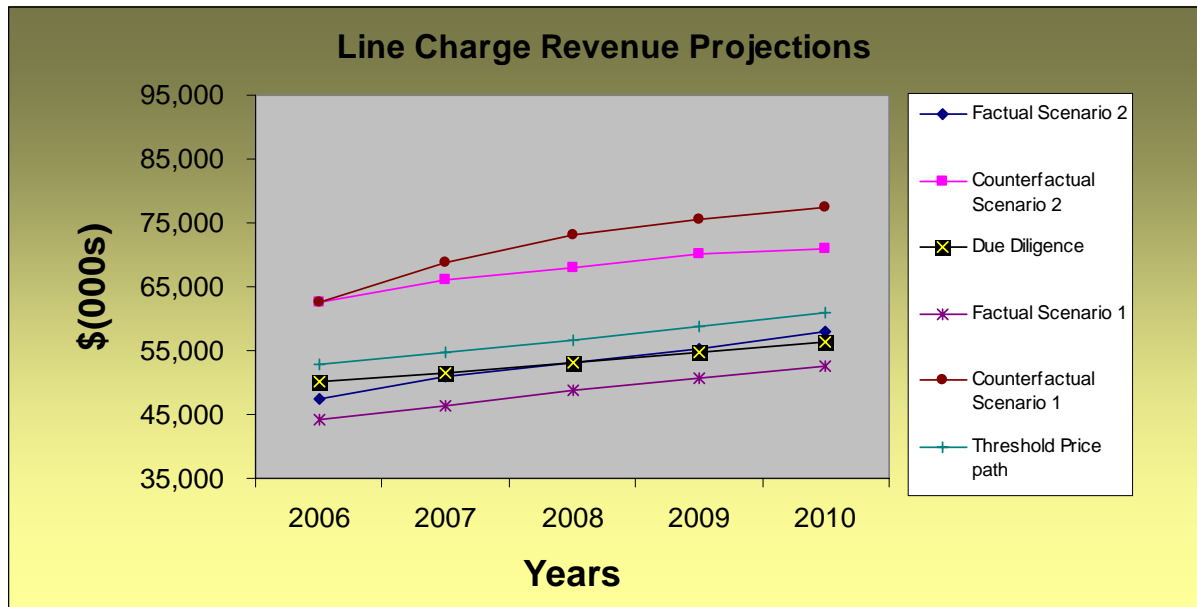
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<sup>91</sup> Commerce Commission, *supra* n 2, pp 65-66 and Figure 5.

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 85).

- 195 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>92</sup>

**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 192-193 & 195). For the purposes of this paper it proxies a counterfactual relevant to the evaluation of Unison's Revised Offer (paragraph 201).

**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 192-194).

**Threshold Price Path** corresponds to estimates made in the Intention Paper of the revenue permitted under Unison's existing price path threshold (paragraph 192). 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 200).

**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 101).

**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 101 & 202). For the purposes of this paper, it proxies an additional counterfactual scenario corresponding to control (paragraph 203).

- 196 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

<sup>92</sup> *ibid*, paragraphs 228-229.

appropriate alternative factual scenario, rather than a counterfactual scenario to be compared to a factual that represents likely outcomes under control.

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

- 197 The current decision the Commission faces is to decide whether Unison’s Revised Offer should be accepted. If accepted, the expected outcomes from implementing the terms of the settlement would provide the justification for the Commission’s decision not to declare control. Therefore, as discussed above (paragraphs 127-128), 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.
- 198 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 129). 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).
- 199 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 85), and in April 2006 the company reversed its earlier price increases to Rotorua and Taupo consumers (paragraph 107). 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.
- 200 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.
- 201 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 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.

***Benefits of the Revised Offer versus a “control” counterfactual***

- 202 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 136).
- 203 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 172 and 180).<sup>93</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 67).
- 204 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 189). 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).
- 205 As reiterated above (paragraph 135-138), 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 from the end of that period, 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.
- 206 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

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<sup>93</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.

industry given that it signals the Commission's regulatory commitment to a medium-term price path, thereby contributing to regulatory certainty and stability (paragraph 139). 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.

- 207 The Revised Offer also outlines a tariff rebalancing programme by reference to cost-reflective pricing principles. 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.
- 208 Unison's Revised Offer represents a voluntary arrangement, and therefore direct compliance and regulatory costs are likely to be lower than under control (particularly given mitigated litigation risk). Monitoring of the settlement compliance is, however, important for the effectiveness of the arrangement and for the desired benefits for consumers to be achieved.
- 209 In this regard, the Commission notes that Unison's future threshold compliance statements, combined with its disclosures under the new pricing methodology requirements, will 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 revised information disclosure requirements—to be gazetted early in 2007, following consultation—will require that Unison report on actual versus forecast spend for all its capital expenditure (including renewals and network augmentation), and explain any variances.
- 210 Furthermore, should it accept Unison's offer, 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 181). These reviews would 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 would be preserved through the arrangement, monitoring would ensure that Unison is also accountable for making its planned investments—consistent with the Purpose Statement and with clause 8(b) of the GPS.

***Summary of net benefits from accepting and implementing the Revised Offer***

- 211 In sum, 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 voluntary compliance with its existing thresholds, and its commitment to addressing the s 57E concerns identified in the Commission's intention to declare control, would 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 to maintain network performance would 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 would 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 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 from the end of that period;
- positive impacts on investment incentives for the wider industry would likely stem from the regulatory stability signals provided by the Commission in reinforcing its commitment to a medium-term price path;
- with any voluntary settlement there is a possibility of non-compliance, but the Commission considers it would be relatively straightforward to monitor the implementation of the settlement; and
- Unison's asset management plans, capital and maintenance expenditure, and its reliability performance would also be subjected to regular reviews by the Commission.

## **DRAFT DECISION NOT TO DECLARE CONTROL OF UNISON**

### **Commission's Preliminary Acceptance of Unison's Revised Offer**

- 212 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, as is set out in the previous section, the Commission's current view is that control is *not* necessary to address the s 57E concerns identified in the Intention Paper (paragraph 103), because these concerns would be appropriately addressed through acceptance and implementation of the Revised Offer.

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

- 213 While control would limit Unison's ability to extract excessive profits, Unison's voluntary compliance with its existing price path threshold (paragraph 148-150) would, in the Commission's view, achieve the same objective at lower administrative and compliance costs (paragraphs 184, 187, 201, 204 and 208). Furthermore, Unison's incentives to invest to maintain network performance will be preserved over the settlement period, because the company would 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 166-167, 178 and 203). In addition, monitoring by the Commission would ensure that Unison is accountable for making its planned investments (paragraph 210).

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

- 214 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 compliance with the price path threshold would result in further price reductions for all consumers, on average (paragraph 155).
- 215 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 from the end of that period. 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 202-206).

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

- 216 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 151-163). Unison's planned tariff

rebalancing programme espouses cost-reflective pricing principles, and would 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 207).

### ***System reliability***

- 217 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 179-182).

### ***Commission's preliminary view***

- 218 In conclusion therefore, the Commission's preliminary view is 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 would 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.

## **Next Steps**

### ***Process timetable***

- 219 Submissions are invited on the Commission's preliminary view that Unison's Revised Offer should be accepted, as well as on the Commission's settlement evaluation framework. Submissions are not limited to the matters raised in this paper, but may address any matters relevant to the Commission's post-breach inquiry of Unison. Interested parties will also have the subsequent opportunity to make cross-submissions.
- 220 The timetable for the consultation process is as presented in Table 5.

**Table 5: Process Timetable**

| <b>Scheduled Date</b> | <b>Event</b>                       |
|-----------------------|------------------------------------|
| 9 November 2006       | The Commission releases this paper |
| 29 November 2006      | Submissions on this paper due      |
| 11 December 2006      | Cross-submissions due              |

### ***Confidentiality***

- 221 Parties making submissions may wish to provide confidential or commercially sensitive information to the Commission. Parties can request that the Commission make orders

under s 100 of the Act in respect of information that should not be made public. Any request for an s 100 order must be made when the relevant information is supplied to the Commission and must identify the reasons why the relevant information should not be made public. The Commission will provide further information on s 100 orders if requested by parties, including the principles that are applied when considering requests for such orders.

- 222 Any s 100 order will apply for a limited time only as specified in the order. Once an order expires, the relevant information is then subject to the Official Information Act. If, following expiry of the order, the Commission receives a request for disclosure of information formerly privileged to the s100 order, it will consult with the party that provided the information as to whether the information should remain confidential (and, if so, why). The Commission can decline requests for information on the grounds set out in the Official Information Act. Any decision by the Commission to withhold information is subject to appeal to the Ombudsman.
- 223 The Commission discourages requests for non-disclosure of submissions, in whole or in part, as it is desirable to test all information in a fully public way. It is unlikely to agree to any requests that submissions in their entirety not be made public. However, the Commission recognises there will be cases where information should not be published. If it is necessary to include such material in a submission the information should be clearly marked and preferably included in an appendix to the submission. Interested parties should provide the Commission both confidential and public versions of their submissions in both electronic and hard copy forms. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

### ***Receipt of submissions***

- 224 The Commission intends publishing all submissions (including cross-submissions) on its website. Accordingly, the Commission would prefer receiving these in electronic form. If the submission does not contain confidential information, it is not necessary for interested parties to send the Commission hard copies of their submissions, unless it is not possible to do so electronically.
- 225 Submissions should be sent to:

E-mail: [electricity@comcom.govt.nz](mailto:electricity@comcom.govt.nz); or

Unison Post-Breach Inquiry  
Network Performance Group  
Networks Branch  
Commerce Commission  
P.O. Box 2351  
Wellington

### **Possible Outcomes of the Post-Breach Inquiry**

- 226 After having regard to the views of interested parties, which will include the information from submissions and cross-submissions on this paper, the Commission will make a final decision whether to accept Unison's Revised Offer.

- 227 If the Commission's preliminary view set out in this paper is confirmed and Unison's Revised Offer is accepted, then the Commission would be able to close its post-breach inquiry into all of Unison's past threshold breaches. Subsequently, in accordance with s57H(d)(ii) of the Act, the Commission would publish its reasons for not making a control declaration in the *Gazette*.
- 228 The Commission notes that, given the process timetable outlined above, its decision whether to accept the Revised Offer is likely to be made after Unison has already implemented its first round of voluntary price changes (i.e., on 1 December 2006). It is possible that consultation may raise issues that Unison itself considers appropriate to address through amendments to the current Revised Offer.
- 229 For instance, interested parties may raise valid issues concerning various aspects of Unison's Cost of Supply model, given that the model results in a significant change to Unison's pricing methodology. Hence, the Commission remains open to the prospect that Unison may respond to the views of interested parties by proposing amendments to the Revised Offer, and that these amendments could impact Unison's proposals for the second round of tariff rebalancing scheduled for 1 April 2007. Should such a situation arise, the Commission might consider it appropriate to accept the Revised Offer subject to those amendments.
- 230 If, after taking into account the views of interested parties on this paper, the Commission decides not to accept Unison's Revised Offer, then the Commission would still need to decide whether to declare control of the electricity distribution services supplied by Unison. In making such a decision, the Commission may need to undertake further investigations and analysis, and therefore may seek further information from Unison. The Commission may also undertake another round of consultation to seek the views of interested parties if the Commission considers that control may still be warranted.
- 231 If a declaration of control is made under Part 4A of the Act in respect of services supplied by Unison, then the Act provides for the making of a provisional authorisation, to be followed by a subsequent consultation process under Part V of the Act, before any final authorisation is made (or an alternative undertaking is accepted from Unison). Any or all distribution services provided by Unison may be subject to control, and authorisations may be made in respect of all or some components of the prices, revenues or quality standards, using whatever approach the Commission considers appropriate, having regard to the Purpose Statement and the GPS.