

3 July 2018

Open letter

Dear Stakeholder

Requesting feedback on recent customised price-quality path processes

1. In March 2018, we published final decisions on the customised price-quality paths applying to Powerco and Wellington Electricity.¹ We are now seeking feedback on these processes to understand what worked well and what could be improved.

Why we have written this letter

2. Our objective is to learn from each customised price-quality path process, and make adjustments over time that will help make customised price-quality paths more efficient and effective. In doing so, we aim to improve confidence in the customised price-quality path process for future applicants, in a way that delivers maximum value for consumers.
3. Over time, we expect to make improvements that:
 - 3.1 promote better outcomes for consumers through the quality of customised price-quality path proposals;
 - 3.2 provide upfront guidance where there is scope for different approaches under the input methodologies; and
 - 3.3 reduce unnecessary cost and complexity of preparing customised price-quality path proposals.
4. The above considerations essentially represent the balance we are trying to strike to ensure customised price-quality paths are an accessible alternative to the default paths for suppliers, while providing the right level of scrutiny to ensure they promote the long-term interest of consumers.

Providing your feedback

5. We welcome all feedback interested parties may have on improvements to the customised price path process. To help parties providing feedback we have set out a number of topics in Attachment A and provided our emerging view and specific questions for consideration. Parties are not limited to providing feedback on solely these topics however.

¹ *Powerco Limited Electricity Distribution Customised Price-Quality Path Determination 2018 [2018] NZCC 5, Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018 [2018] NZCC 6.*

Attachment A: Topics for feedback

- a. Consideration of alternatives
 - b. Use of cost benefit analysis
 - c. Long term pricing impact
 - d. Calculating revenue and pricing changes
 - e. Delivery and accountability of customised price-quality path commitments
 - f. Link between price and quality
 - g. Consumer consultation
 - h. Verification
 - i. Defining and applying proportionate scrutiny
6. Attachment B sets out further views on a proposed method for calculating price impact in relation to Table D in Attachment A.
7. We are also seeking general feedback on the effectiveness of changes made in the 2016 IM review that are summarised in the below table.

Summary of changes made during the 2016 IM review

- a. Flexibility to apply for modifications and exemptions to input methodologies requirements
- b. Ability to use alternate methodologies that have equivalent effect
- c. Adoption of a single WACC for default and customised price-quality paths
- d. Clarification of the role and purpose of the verifier
- e. Alignment of information requirements with information disclosure
- f. Introducing the concept of proportionate scrutiny in applying our assessment approach

8. The focus of this open letter relates to customised price-quality path application processes for electricity distribution businesses. However we also welcome any feedback that may also be relevant to the customised price-quality path application processes for the gas sector.

Timing and next steps

9. We welcome your feedback by 31 July 2018. Cross-submissions are due by 14 August 2018.
10. Please address your feedback to Matthew Lewer, Regulation Branch and email to regulation.branch@comcom.govt.nz. Please include in the subject line: "Feedback on recent customised price-quality path processes".
11. We will publish the feedback we receive and provide an update on next steps after receiving submissions.

Kind regards

A handwritten signature in blue ink, appearing to be 'ML', followed by a period.

Matthew Lewer
Manager, Regulation Development

Attachment A: Topics for feedback

Table A: Consideration of alternatives

Overview	Applicants are not required to consult with third parties on potential solutions when preparing their proposals. This means that where an applicant chooses not to consult with third parties, they may not have considered alternative solutions that better promote the long-term interests of consumers.
What stakeholders have told us	Contact Energy submitted that it considered it could have provided a lower-cost solution compared to a proposed network investment promoted by Powerco in its proposal. For future applications, Contact suggested that an external consultation process should be required to ensure applicants adequately consider the full range of potential solutions prior to submitting their application.
Our view	<p>Whilst we were ultimately satisfied that the solutions chosen by Powerco were appropriate, we consider there is merit in a formal process for applicants to consult with third parties on alternative solutions in the development of their proposal. This would provide greater transparency and confidence in the solutions proposed by the applicant, and potentially reduce cost where an alternative solution proposed by a third party is adopted.</p> <p>We note a similar process is required of Transpower as part of the Transpower Capital Expenditure Input Methodology.² Transpower is required to consult with stakeholders on major capital investments greater than \$20 million, including on any non-transmission solutions. In addition, Transpower must report yearly on the engagement it does with stakeholders on investments under \$20 million.</p>
Feedback requested	<p>We welcome submitters' views on whether similar approaches to that for Transpower should be considered for customised price-quality path applicants, including:</p> <ol style="list-style-type: none"> 1. Whether we should require market testing of major investments, and if supported then: <ol style="list-style-type: none"> 1.1. What is an appropriate threshold to require market testing (eg, minimum dollar value of a project before it is required to be market tested); 1.2. What information and processes should be required for market testing; and 1.3. When the market tested should be conducted, with reference to the CPP application date.

² Commerce Commission, Transpower capex input methodology review Decisions and reasons , 29 March 2018, para 302-323

Table B: Use of cost-benefit analysis

Overview	The evaluation criteria used to assess customised price-quality path proposals does not explicitly require the use of cost-benefit analysis to determine whether a proposal promotes the Part 4 purpose.
What stakeholders have told us	<p>During the Powerco customised price-quality path process, we received multiple submissions on the role of cost-benefit analysis when assessing whether a customised price-quality path proposal promotes the long-term benefit of consumers. Submitters generally had two views:</p> <ul style="list-style-type: none"> • The Commission should be required to undertake a formal cost-benefit analysis (ie, a quantification of the costs and benefits across the full scope of the proposal) to justify that the customised price-quality path it sets promotes the purpose of Part 4 of the Commerce Act 1986 (the Act).³ • The introduction of cost-benefit analysis would represent a changing of the rules that undermines regulatory certainty.⁴
Our view	<p>In our final decision on Powerco’s customised price-quality path, we stated our view that we were not required to apply a cost-benefit analysis quantifying the full costs and benefits of Powerco’s proposal to determine whether the customised price-quality path we set promoted the purpose of Part 4.</p> <p>We considered our evaluation criteria, consulted on as part of the input methodologies review in 2016, was a sufficient test to determine a customised price-quality path consistent with the purpose of Part 4. We also agreed with submitters who suggested adopting cost-benefit analysis as a formal test after Powerco had submitted its proposal to us, would risk undermining the confidence of suppliers to prepare and submit customised price-quality path proposals.</p> <p>We have not changed this view but we recognise that cost-benefit analysis is a useful tool to inform judgement and there is merit in exploring its role in the customised price-quality path process going forward, in particular as effective asset criticality frameworks are established.</p>

³ TDB Advisory on behalf of ERANZ "Submission on Powerco CPP Issues paper" (22 September 2017), para 1.2; NZIER "Powerco CPP application: Advice to MEUG for Commerce Commission submission" (22 September 2017); Pat Duignan "Submission by Pat Duignan re Commission Draft Decision on Powerco CPP Proposal" (15 December 2017).

⁴ Aurora "Submission: Powerco’s proposal to customise its prices and quality standards, Draft Decision" (15 December 2017).

Feedback requested	<p>We would like to hear your views. In particular, we are interested in:</p> <ol style="list-style-type: none"> 1. areas of potential customised price-quality path proposals that could be the focus of further work to understand how benefits can be quantified (eg, health and safety); 2. how an asset criticality framework could help support identifying expected benefits of additional expenditure; and 3. potential changes to the customised price-quality path requirements that could help support the use of cost benefit analysis as a tool to inform customised price-quality path proposals.
--------------------	--

Table C: Long term pricing impact

Overview	<p>Applicants are required to consult on the price impact of their proposal for the period of their proposed customised price-quality path. This does not capture the full price impact of their proposal, where capital expenditure towards the end of the customised price-quality path period is only partially recognised in the price path until the subsequent regulatory period when it enters the regulatory asset base.</p>
What stakeholders have told us	<p>For the Powerco customised price-quality path we first presented our view of the price impact of Powerco’s proposal on the subsequent period in our Issues paper. We considered this important for transparency and so that consumers could provide additional views to those they expressed in Powerco’s consultation process when provided with new information.</p> <p>Submitters generally agreed that it was important to provide consumers with as much information as possible on the price impact of customised price-quality path proposals.</p> <ul style="list-style-type: none"> • Consumers, particularly MEUG and ERANZ, considered that price impact on subsequent period should be required as part of the customer consultation process undertaken by all customised price-quality path applicants. • Submissions from suppliers cautioned against a formal requirement, as prices in subsequent periods are subject to greater uncertainty and difficult to represent with confidence.
Our view	<p>In order to increase transparency, we consider customised price-quality path applicants should be required to consult with their consumers on the indicative long term price impacts of their proposals. We acknowledge there is significant uncertainty around the extent of the subsequent price increase, however, our view is that the benefit of additional transparency to</p>

	consumers regarding the price/quality trade-off in an expenditure proposal outweighs the limitations in the analysis. ⁵
Feedback requested	<p>Please provide us with your feedback on whether:</p> <ol style="list-style-type: none"> 1. an applicant should be required to consult on the long term price impact of its proposal; 2. the option of making an input methodology amendment is appropriate; and 3. there are other options available that will encourage applicants to consult on the long term pricing impact.

Table D: Calculating revenue and pricing changes

Overview	There is no established methodology for calculating and communicating price changes relating to customised price-quality path proposals and decisions. This means there is potential for inconsistency in the price calculation used by the customised price path applicant to consult on its proposal, and the calculation used by the Commission for the customised price-quality path decision.
Our view	<p>We consider there should be a standard approach to calculating revenue and price changes to be used by both customised price-quality path applicants and the Commission. A standard approach provides for better comparison and easier explanation of price changes for consumers. It should also reduce time spent by the applicant and the Commission understanding how price changes have been calculated.</p> <p>We also consider the standard approach should be adopted for the Commission’s decisions on default price-quality paths.</p>
Feedback requested	<p>Please provide us with your feedback on:</p> <ol style="list-style-type: none"> 1. whether there are any issues in using a standard approach to calculating revenue and price changes consistently for consumer consultation purposes as well as in our customised price-quality path decisions; 2. whether our proposed approach to calculating these changes and the assumptions we make as outlined in Attachment B are appropriate; 3. whether focusing the analysis on the ‘typical consumer’ as outlined in Attachment B is appropriate; and 4. whether there are any other relevant consumer types that should be included in this analysis and, if included, where the necessary

⁵ Commerce Commission “Powerco’s customised price-quality path final decision” (28 March 2018), para 521.

	information could be sourced from.
--	------------------------------------

Table E: Delivery and accountability of CPP commitments

Overview	<p>Suppliers are not formally required to demonstrate:</p> <ul style="list-style-type: none"> • greater accountability for increases in revenue; or • how they are delivering on commitments for which they have been funded under a customised price-quality path.
What stakeholders have told us	<p>Stakeholders have told us applicants should be more accountable and transparent in their spending under a customised price-quality path, and that applicants need to be held to account for their previous, current and future investment decisions.</p>
Our view	<p>We agree that customised price-quality path applicants should demonstrate how they are delivering their commitments in a way that is easy for stakeholders to understand.</p> <p>Customised price-quality paths provide for increases in revenue that have been justified against specific needs. As the increase in revenue is funded via its consumers, it is important that an applicant is accountable for delivering on the commitments set out in its customised price-quality path proposal.</p> <p>We consider at a minimum the applicant should provide transparency in its progress towards delivery, and this should be done with the consumers who are funding the proposal at its core. For Powerco’s customised price-quality path, we decided to require Powerco to produce an Annual Delivery Report to achieve this.</p> <p>A wider set of quality measures would help establish greater accountability and help ensure that the services provided reflect consumer demands. Our view is that a customised price-quality path applicant should propose measures, beyond those that are required by a default path, that are closely linked with the key drivers of its proposal to establish greater accountability.</p>
Feedback requested	<p>Please provide us with your feedback on whether:</p> <ol style="list-style-type: none"> 1. there needs to be improved transparency that demonstrates a customised price-quality path applicant is delivering the commitments for which it has been funded in a transparent and easily understandable way; 2. an applicant should be required to provide a stakeholder facing delivery report that sets out how it is delivering the major projects and wider commitments it has been funded for under a customised price-quality path; and 3. it is appropriate to require customised price-quality path applicants to propose additional quality measures that are closely

	linked with the key drivers of its proposal to establish greater accountability for increased revenue, and whether these should be linked with revenue.
--	---

Table F: Link between price and quality

Overview	Customised price-quality path applicants are not required to demonstrate the impact of individual investments on quality outcomes for consumers.
What stakeholders have told us	In its submission on the Powerco customised price-quality path draft decision MEUG highlighted the difficulties faced in setting quality standards when the linkage between investment and quality outcomes is not clear.
Our view	<p>We consider understanding the impact of individual investments on quality outcomes important for two reasons:</p> <ul style="list-style-type: none"> • Where an applicant understands the impact of specific expenditure on quality, it is likely to be able to better prioritise where it targets its expenditure. We expect this will lead to better quality customised price-quality path proposals as more information is available to the applicant to refine its asset management strategy. • Where there is a direct link between price and quality, it is easier for consumers to make their preferences clear, and for the Commission to make necessary judgements when setting customised price-quality path. <p>Asset management is one of the Commission’s priorities for the electricity sector as signalled in our recent open letter. In the letter, we stated that an understanding of asset criticality to be a key aspect of good asset management practice.</p> <p>We have also recently presented a paper at the 2018 EEA conference where we tested how an asset criticality framework might work, what information would be required to make it work, and whether the results from such a framework would prove useful.</p> <p>We consider that an analytical understanding of asset criticality can inform decision making on investment strategies as they may affect different quality outcomes.</p>
Feedback requested	<p>We want to better understand how an asset criticality framework could be adopted to support customised price-quality path proposals. In particular:</p> <ol style="list-style-type: none"> 1. What is the current practice within the sector for making decisions on investment trade-offs, and communicating trade-off decisions? 2. What are the potential compliance costs of implementing an

	<p>asset criticality framework?</p> <p>3. What is preventing asset criticality being implemented across the sector?</p> <p>4. How do price and quality trade-offs get communicated to consumers so they can more meaningfully engage?</p>
--	---

Table G: Consumer consultation

Overview	<p>The requirements for applicants to consult with consumers on their proposal are specified at a high level. This is intended to provide applicants with flexibility in how they engage with their consumers, recognising that there is likely no ‘one size fits all’ solution given:</p> <ul style="list-style-type: none"> • applicants have thousands of consumers; • consumers are often not engaged; and • it is very hard to articulate trade-offs in a way that can be understood by everyday consumers, and are still meaningful.
Our view	<p>Powerco spent considerable time and effort on their consumer engagement – we consider it was genuine and met the input methodologies requirements. However, we are not convinced that it was as meaningful as it could be, or had a meaningful impact on its proposal. In our view, the engagement could have:</p> <ul style="list-style-type: none"> • provided more detail and/or optionality; and • better articulated the price and quality trade-offs of different options on the typical household bill. <p>We do not have an obvious solution that would mean better consultation however. In light of this we consider, we should explore ways in which the consumer consultation can be improved ahead of further customised price-quality path applications.</p>
Feedback requested	<p>In particular, we are seeking your views on:</p> <ol style="list-style-type: none"> 1. whether a process is required to align expectations between the Commission and applicant prior to consultation being undertaken; 2. the role of specific tools such as consumer panels; 3. scope for specifying the existing requirements to provide further clarity; and 4. the role of incentives at improving consumer engagement to get better long-term outcomes for consumers.

Table H: Verification

Overview	Verification is a key component of the customised price-quality path process which allows the applicant to test, and remedy, its proposal prior to submission, and provides the Commission with key information to inform its judgement and help make its decisions within statutory timeframes. It is however, a unique arrangement that requires effort to ensure it is successful over time.
Our view	<p>Overall we consider the verification process for Powerco to be successful. Powerco was provided with confidence that a large proportion of its proposal was justified in the opinion of the verifier, and once satisfied with the Verfier’s conclusions, we were able apply a more targeted approach in our assessment.</p> <p>We have however identified some minor areas for improvement and are aware of some issues identified by Powerco and the verifier, Farrier Swier, that could be addressed ahead of future customised price-quality path applications.</p>
Feedback requested	<p>We would like to hear your views on the following:</p> <ol style="list-style-type: none"> 1. whether the present verifier flexibility is sufficient and if the verifier should be required to signal early in the verification process the projects and programmes that they intended to verify; 2. should we be more prescriptive about the extent of the material required for the verified projects and programmes, keeping in mind that the Commission may also request additional material during its own assessment of the proposal; 3. whether we need to formalise the applicant information provision requirements to ensure information is provided to the verifier in a timely manner; 4. whether a verifier emerging views paper or preliminary report has merit; 5. whether the boundary between the audit and verification processes is sufficiently clear and if not, how can it be improved; 6. Have the changes to the verification process, made during the last input methodologies review, improved the verification and Commission customised price path assessment processes.

Table I: Defining and applying proportionate scrutiny

Overview	The concept of proportionate scrutiny was introduced as part of the 2016 IM review and intended to provide guidance on how the Commission might adjust its assessment approach to different types of proposals and issues within proposals.
What stakeholders have told us	A number of stakeholders (namely Wellington Electricity and First Gas) have indicated that the Commission should provide further clarity around the principles of proportionate scrutiny and how it is applied by the Commission.
Our view	<p>Our view is that the principle of proportionate scrutiny is sufficiently defined within the current customised price-quality path requirements.</p> <p>By its nature, it is extremely difficult to provide a definitive codified definition of how the principle of proportionate scrutiny will be universally applied to customised price-quality path applicants. This is because the particular circumstances of each customised price-quality path applicant will be different based upon their own unique set of circumstances and future investment requirements (which is after all why they are applying for a customised price-quality path).</p> <p>Furthermore, providing a definitive description of proportionate scrutiny, and when it may or may not be applied, could fetter our discretion in making future decisions that may not be in the long term interests of customers. For example, we would not want such a codified definition to restrict us in our assessment of customised price-quality path proposals, or in responding to dynamic industry changes in the setting of quality standards that better reflect customers' needs and achieve the purpose of Part 4.</p> <p>We think it is important that proportionate scrutiny should not be used as a lever for potential applicants to limit or attempt to control the scope of assessing a customised price-quality path application.</p>
Feedback requested	<p>Please provide us with your feedback on:</p> <ol style="list-style-type: none"> 1. your view regarding the current definition of proportionate scrutiny and whether you consider this is sufficient and provides enough clarity to potential customised price-quality path applicants; 2. whether you believe there is a need for the Commission to better define the principle of proportionate scrutiny and the circumstances when it may be applied in practice; and 3. any further steps you think could be taken by the Commission to provide more certainty to all industry participants and stakeholders about how customised price-quality path applications will be assessed?

Attachment B: Communicating changes in revenues and prices

12. How revenue and pricing changes are expressed to consumers is an important consideration when electricity distributors consult with them when preparing a customised price-quality path application, or when we communicate the effects of our default and customised price-quality path decisions.
13. This attachment sets out a proposed standardised approach for expressing to a general audience:
 - 13.1 Expected changes in an electricity distributor's revenue; and
 - 13.2 Indicative pricing effects on a *typical consumer's* total electricity bill.
14. The outcome of this proposed approach enables applicants and us to:
 - 14.1 express the expected % revenue change (to 2 significant figures) for a specific supplier, which is the difference between the forecast or allowed maximum allowable revenue and a relevant counterfactual;
 - 14.2 express \$ price increases or decreases (to the nearest 10 cents) in terms of a typical consumer's monthly bill on a specific supplier's network;
 - 14.3 provide an estimate of the typical consumer's monthly bill to provide context for the \$ price change; and
 - 14.4 provide context for when we expect the price change will take effect (eg, over the next 5 years; from 2020).

Communicating expected changes in revenue

15. The main point we want to communicate here is the expected change in revenue of a proposal or decision against a relevant counter-factual. As highlighted in Attachment A, there are two points in time that are relevant:
 - 15.1 At the outset of each regulatory period, and
 - 15.2 At the start of a subsequent regulatory period, when a supplier transitions off its customised price-quality path.

Change in revenue at the outset of each regulatory period

16. Our proposed calculation is set out in the table below, in which:
 - 16.1 revenues exclude the effects of pass through costs and recoverable costs, including wash-ups and transmission costs;
 - 16.2 figures are GST exclusive;
 - 16.3 the relevant counterfactual is an estimate provided by the supplier; and
 - 16.4 we express the calculated change to 2 significant figures.

Table J:

	Descriptor of variable	Formula	Data source
a	Estimate of year X distribution revenue allowed under DPP (\$m)		Provided by supplier
b	Initial year's (year X) maximum allowable revenue under CPP (\$m)		Supplier's estimate, or Commission decision
c	Increase in revenue (%)	$b/a-1$	

Change in revenue at the start of a subsequent regulatory period

17. This scenario is likely to be relevant for customised price-quality paths only, where investments are above historic levels and the full effect does not flow through to revenues until price paths are reset.
18. We recognise that there are a number of uncertainties in calculating the change in revenue for this point in time, and therefore propose a number of simplifying assumptions.
19. Our proposed calculation is set out in the table below, in which:
 - 19.1 revenues exclude the effects of pass through costs and recoverable costs, including wash-ups and transmission costs;
 - 19.2 figures are GST exclusive;
 - 19.3 the relevant comparators are:
 - 19.3.1 the last year's maximum allowable revenue inflated by CPI; and
 - 19.3.2 an estimate of the maximum allowable revenue in the first year of a subsequent 5 year price path – a number of necessary assumptions are set out in the table;
 - 19.3.3 we express the calculated change to 2 significant figures

Table K:

	Descriptor of variable	Formula	Data source	Comments
a	Last year's (year X) maximum allowable revenue under CPP inflated by CPI (\$m)		Supplier's estimate, or Commission decision	
b	Estimate of year X+1 maximum allowable revenue for subsequent 5 year price path		Supplier's estimate, or Commission calculation	Modelled price path assumes: <ul style="list-style-type: none"> • Opening RAB equals closing RAB from previous CPP • WACC remains constant • Expenditure forecasts from supplier's asset management plan
c	Increase in revenue (%)	b/a-1		

Communicating indicative pricing effects for a typical consumer

20. The main point here is to communicate to a general audience the indicative effect of a proposal or decision on the total electricity prices observed by consumers. This means it's not limited to communicating changes to the distribution component, or attempting to reconcile other price effects that may be observed by consumers.
21. To do this we express price effects in terms of a "typical consumer". We chose this approach compared to using an average consumer or another metric as it can be transparent about the characteristics of the consumer, it allows for comparability between suppliers and it relies on publicly available information.
22. The typical consumer reflects a hypothetical consumer described by MBIE in its *Quarterly Survey of Domestic Electricity Prices*, which is likely to capture some residential and commercial consumers:

"Modelled NZ Consumer - 22 kWh per day on cheapest low user tariff available without a fixed term contract."
23. We are deliberate in the use of the term *indicative* pricing effects. It recognises that we cannot be definitive about how prices will in fact change at a total electricity bill level, given distribution charges only make up a component of the bill and retailers have discretion on how they pass on costs.
24. We use a total monthly electricity bill as the point of reference for which most consumers can relate price changes to.

Change in prices for a typical consumer

25. Our proposed calculation is set out in the table below, in which:

25.1 figures are GST exclusive;

25.2 we rely on certain MBIE data, which is available [here](#); and

25.3 we round the calculated price change to the nearest 10 cents.

Table L

	Descriptor of variable	Formula	Data source	Comments
a	Total typical consumer's annual bill (\$)		MBIE, Quarterly Survey of Domestic Electricity Prices	Where there is more than one region that corresponds to the supplier's network, we will use a point estimate taken by inspection – eg, for Powerco we used annual bill of \$2500 which is taken by inspection from the 7 red data points highlighted in Figure x below This figure can be used to derive an estimate of a typical consumer's monthly bill to provide context for a \$ price change
b	Proportion of total typical consumer's bill that is from distribution charges (%)		MBIE, Quarterly Survey of Domestic Electricity Prices	Where there is more than one region that corresponds to the supplier's network, we will use the national figure – eg, for Powerco we used the national figure of 28.4% as seen in Figure y below
c	Typical consumer's annual distribution charges (\$)	$a*b$		
d	Change in distribution charges (%)			Calculated in table J above as 'Increase in revenue (%)'
e	Change in typical consumer's annual distribution charge (\$)	$c*d$		
f	Change in typical consumer's monthly distribution charge (\$)	$e/12$		We use this to express the \$ price change in typical consumer's monthly electricity bill

Figure A.1: Total annual bill

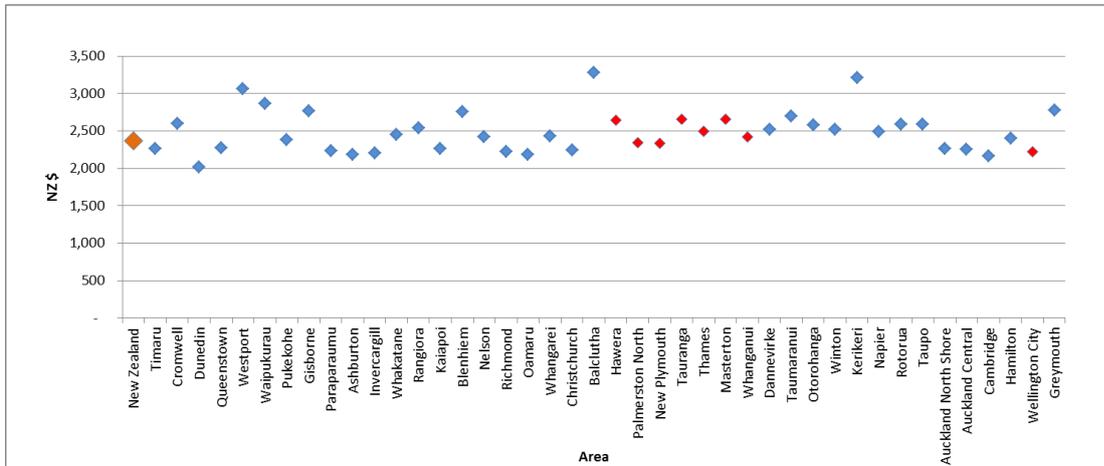


Figure A.2: Proportion of total bill that is distribution

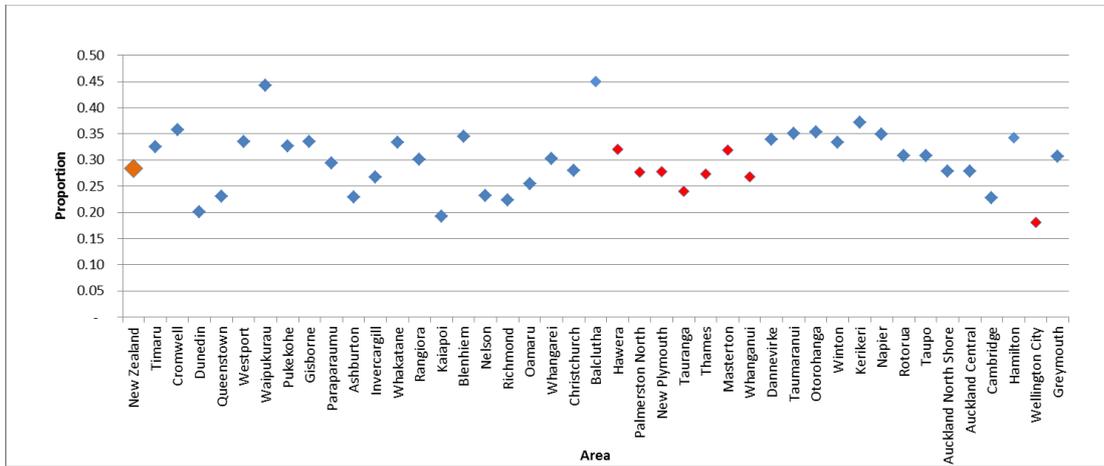


Figure A.3: Annual distribution charge

