

31 July 2018

Matthew Lewer  
 Manager, Regulation Development  
 Commerce Commission  
 By email to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

Dear Matthew

**Feedback on recent customised price-quality path processes**

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission open letter 'Requesting feedback on recent customised price-quality paths applying to Powerco and Wellington Electricity' dated 3<sup>rd</sup> July 2018 (the "CC open-letter").<sup>1</sup>
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. Attached and to be read as part of this submission is a report by Mike Hensen, NZIER report to MEUG, Feedback on CPP process – Advice to MEUG for Commerce Commission submission, 30<sup>th</sup> July 2018.
4. The NZIER report has chapters on the use of cost-benefit-analysis (CBA), long-term price impact, calculating price changes and linking price and quality aligning with the same named topics in the CC open-letter. A guide to where submissions on the 9-topics in the CC open-letter are found follows.

Topic in Attachment A	NZIER advice	This cover letter
a. Consideration of alternatives		Paragraphs 7 to 9
b. Use of cost benefit analysis	Chapter 1	Paragraph 5
c. Long term pricing impact	Chapter 2	Paragraph 5
d. Calculating revenue and pricing changes	Chapter 3	Paragraph 5
e. Delivery and accountability of CPP commitments		Paragraphs 10 to 11
f. Link between price and quality	Chapter 4	Paragraph 5
g. Consumer consultation		Paragraphs 12 to 16
h. Verification		Paragraphs 17 to 19
i. Defining and applying proportionate scrutiny		Paragraph 20

<sup>1</sup> URL <http://www.comcom.govt.nz/dmsdocument/16389> at <http://www.comcom.govt.nz/regulated-industries/electricity/cpp/cpp-proposals-and-decisions/wellington-electricitys-2018-2021-cpp/>

5. We have no feedback on the effectiveness of relevant CPP Input Methodology (IM) changes in 2016, as requested in paragraph 7 of the CC open-letter because we have not analysed the likely outcome before and after the changes for the 2-CPP applications considered since the IM were changed.

**NZIER advice on topics – b, use of cost benefit analysis; c, long term pricing impact; d, calculating revenue and pricing changes; and f, link between price and quality.**

6. As noted in paragraph 4 the NZIER advice covers the 4-topics listed in the section header above. These 4-topics are interrelated and as a group, in the view of MEUG, the most material topics of those listed in the CC open-letter. The key points summary from the NZIER advice is repeated below:

## Key points

The Commerce Commission requirements for cost benefit analysis of major electricity network investment are not consistent across Transpower and EDB. The Commerce Commission has correctly pointed out that recent decisions about the input methodology processes did not specify the use of cost benefit analysis (CBA) for the assessment of customised price path (CPP) proposals. However:

- CBA is used to assess major capital project proposals
- submissions on the Powerco CPP by TDB and Pat Duignan have argued strongly that CBA methods are key component of the 'prudent expenditure' test that the Commission applies to CPP proposals
- some stakeholders have indicated a strong desire to test the costs and benefits of major investment proposals.

Building on the Commerce Commission's willingness to consider the use of cost benefit analysis as a tool to inform assessment of customised price paths it would be useful to agree some principles for the expected scope, approach and duration of cost benefit analysis. We suggest the analysis should include consumer willingness to pay for change in quality of service (planned and unplanned), be compared to a genuine counterfactual (or at least the DPP and explicitly consider) the projected state of the network at the end of the CPP. The benefits of improved health and safety and improved capacity to accept new connections should be quantified and compared to other quantified costs and benefits if the applicant or the Commission regard them as a material element of the rationale for approving the CPP proposal.

A standard approach to calculating the price changes for consumers should be implemented but it should be based on the EDB's pricing methodology and 'cost to serve consumer' models. The price change should be reported for major price plans. This approach would allow consumers to link the change in charges proposed under the CPP to their current charges and would avoid creating an artificial comparator.

Links between prices and quality of service are a key component of the choice offered to consumers in a CPP. We agree that asset criticality would improve the quantification of this trade-off but there are also opportunities to make better use of existing asset health and failure data that is available to and used by the relevant EDB now. There is no need to postpone a more rigorous CBA based assessment of price quality trade-offs based on better use of existing asset health indicators until a better measure of asset reliability (criticality) is available.

## Topic a, Consideration of alternatives

7. All EDB, be they applying for a CPP, subject to DPP or only regulated by information disclosure, should consult with third parties as if they were in a workably competitive market setting. MEUG is cautious on over-regulating EDB to dampen innovation by EDB and mindful at the same time of the risks of EDB using their monopoly position to thwart other parties innovating.
8. The Part 4 regulatory framework we think is in flux and will need to be modified as emerging technologies and new business models become economic. There is no master-plan or roadmap of how this might play out. MEUG's approach to each issue, such as this topic being consideration of line alternatives, is to overcome barriers towards facilitating progress towards an unknown future that we think will have more informed individual consumers, their retailers and agents, and line service providers using a range of technologies to manage line costs and service levels. More and better-quality information, devolved decision making at a more granular level underpin the future of emerging technologies and line alternatives.
9. We support in principle requiring CPP applicants to consult on alternatives just as Transpower must consult in certain cases. The reason we support that additional regulatory requirement on CPP applicants is because we think the work by Contact Energy on the Powerco CPP application demonstrated that applicants can miss or skimp on the analysis of feasible options. The reason for this failure may or may not be deliberate. Irrespective of the reason there is a risk of lower cost options not being considered and hence it is worthwhile considering cost-effective interventions. To minimise the additional regulatory requirements MEUG suggests 2-approaches:
  - The applicant should consult on alternatives to traditional distribution line solutions where the incremental change in annual line services to any individual consumer (or class of similar consumers) of line services is material. There are 4 aspects to this approach:
    - A material change in annual line services would be 5%.
    - The incremental material change could be an increase or decrease of 5%.
    - The approach steps away from using an average effect on prices across all consumers of an EDB to using a trigger for materially affected individual consumers (or class of similar consumers).
    - If subsequently the verifier, Commission, stakeholders or consumers identify a situation where a CPP applicant should have consulted on alternatives, because it was material, then the applicant shareholders must cover the costs of the Commission and interested parties considering alternatives.
  - As soon as the applicant provides the Commission, or verifier, supporting material for its application, that material shall be made public. Having all information made public and subject to widespread scrutiny will incentivise EDB to make applications that are more consumer focussed and robust. This approach is based on the view of using sunshine as a disinfectant for abuse of (monopoly) power.

### **Topic e, Delivery and accountability of CPP commitments**

10. MEUG agrees successful CPP applicants should be accountable to their stakeholders and consumers for actual changes in line charges and service levels compared to those promised by the applicant and determined by the Commission. We were and remain ambivalent about the requirement on Powerco to produce an Annual Delivery Report. Once we have seen and considered the first Annual Delivery Report we will be better informed to take a view. Given that caveat an initial view follows.
11. If the consumer consultation is improved before the application is formally lodged then EDB, customers and consumers will have a better benchmark to measure what was promised and what gets delivered at a more granular level. Hence the first step to improving delivery and accountability of CPP commitments is to improve consumer consultation, the topic considered next.

### **Topic g, Consumer consultation**

12. The consultation with stakeholders and consumers ahead of lodging the formal CPP application was, from our point of view, a failure. The failure was not because Powerco had wrong intentions or did not put resources into consultation. The failure was because the consultation requirements did not require the effects on prices and quality of the proposal versus the counterfactual to be made clear and relevant to the many classes and locations of consumer. The question of consumers having relevant information for them to make an informed decision on the proposal versus the counterfactual is considered in the advice of NZIER.<sup>2</sup>
13. MEUG suggests a default minimum process for consumer consultation. A default process will give certainty to a CPP applicant and customers. The possible detriments are:
  - Higher regulatory costs; though given the experience with Powerco a minimum set of requirements may have assisted reduce costs; and
  - Removing an incentive on an EDB to innovate with consultation processes; though the use of default minima rather than restricting EDB to one prescription leaves open the option for EDB to innovate.
14. We think the design of an optimal level of consumer consultation requires early engagement with stakeholders and consumers to design the consultation material and processes. In the 2016 review of IM MEUG discussed the challenges of the consumer consultation process for CPP applicants as follows:<sup>3</sup>

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<sup>2</sup> [include x-refs]

<sup>3</sup> Refer MEUG submission to CC, 4<sup>th</sup> August 2016, URL <http://www.comcom.govt.nz/dmsdocument/14547> at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>

**Topic 2: CPP requirements**

15. MEUG agrees with the policy intent for changes to consumer consultation requirements for CPP applicants.<sup>13</sup> Changes to improve implementation of the draft decision follow:

- a) A separate verifier with expertise in public consultation should be engaged.

We would not expect a specialist in public consultation processes to be the person consumers would have confidence in to provide an informed expert view on EDB cost proposals. Similarly an engineer cannot be considered an expert in public consultation.

A change is therefore proposed to Schedule F, Engagement of a Verifier, to allow for two separate verifiers. One for the proposed new role, purpose and obligations in the Draft IM Electricity Distribution Services (EDS) IM, Schedule G, cl. G2 (1) (g) "... providing an opinion on the extent and effectiveness of the CPP applicant's consultation with its consumers."<sup>14</sup> The other verifier for all of the other roles, purposes and obligations in schedule G.

- b) More prescription is needed in specifying consumer consultation requirements.

The proposed new requirement in the list of information that a CPP applicant must notify its customers is welcome, ie to adequately notify its customers "of the price versus quality trade-offs made in the expenditure alternatives considered in the intended CPP proposal."<sup>15</sup>

There are multiple risks in delivering the intent of this policy. In sub-paragraph a) above we consider a solution to the fact that verifiers of engineering matters may not be qualified to verify consultation processes.

Another risk is a CPP applicant providing insufficient information at one end of the spectrum and at the other detailed information that is impenetrable and incomprehensible to anybody other than industry experts. There is also a risk of misinformation be it unintentional or intentional. The latter should be mitigated by suitably skilled verifiers working as a team.

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<sup>12</sup> Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower, Chapter 6, pp54-55.

<sup>13</sup> Topic paper 2: CPP requirements, Chapter 8, pp81-85.

<sup>14</sup> Draft Electricity Distribution Services IM, Schedule G, cl. G2(1)(g), 22<sup>nd</sup> June 2016

<sup>15</sup> Ibid, proposed new cl. 5.5.1(1) (c).



An example of the difficulties in having appropriate communication of line charge information occurred in prior years when tariffs were reset each year. This led to the EA in April 2015 introducing "guidelines for distributors and retailers on their communications to consumers and the media concerning price changes in order to improve the transparency of consumers' electricity charges".<sup>16</sup> The EA is monitoring uptake of the guidelines and if needed will regulate. If a problem emerges the EA has the option of intervening to ensure the problem is not repeated in future years.

With CPP applications the form and quality of informing consumers of the price versus quality trade-offs is at the discretion of the CPP applicant. Unwittingly or wittingly the communication of this trade-off in a form consumers can understand (and respond to in an informed manner) may miss the mark. There is a risk that a CPP application complete in all aspects apart from adequate information to consumers on price-quality trade-off may be allowed to proceed because tidying up the communication with consumers is deemed important but dispensable to get the CPP completed. The experience of the difficulty of getting good communication to consumers discussed in the paragraph above is a warning that this scenario of a good CPP application other than the consumer consultation requirement is feasible. The example in the prior paragraph had a good regulatory back-stop whereby the EA could intervene should compliance with the guidelines falter. There is no similar incentive on EDB applying for a CPP to ensure their consumer consultation is adequate because the Commission could not regulate a format and details of consumer consultation once an application was lodged and the CPP applicant may never ask for another CPP in the future.

An option to consider is whether it's better to head off the risk of consumers receiving poor information on trade-offs by either prescribing a specific tabular format or process the CPP applicant must comply with. For example:

- A tabular format could require disclosure for each tariff category, for each year ending 31<sup>st</sup> March that the CPP is intended to apply, the CPP applicants forecast of the average, minimum, maximum, 67<sup>th</sup> and 33<sup>rd</sup> percentile prices (see next sentence for definition of price in this context), total tariff class revenues and forecast quality metrics for the proposed CPP, the current DPP and other options considered but not proposed. "Price" in this proposed table means each of the components of a line tariff billed to an end consumer or a retailer and the sum of those components expressed on a c/kWh average equivalent and \$/MW connection capacity average equivalent.
- Alternatively the IM could prescribe a process where a CPP applicant must consult with end consumers or agents for end consumers (retailers or parties such as MEUG and the Electricity Retailers Association of NZ (ERANZ)) to agree the tabular format to satisfy the new requirement to ensure consumers make informed feedback to the CPP applicant. To ensure adequate consultation end consumer and representatives to be consulted could be defined as representing at least a third of total annual consumption provided that there are at least 5 different such consumer or representative parties to avoid the case where there is high retailer and or industrial end-consumer concentration.

There is a cost to both of the above options. MEUG suggests it is worth considering if the additional cost is worth paying if it uncovers consumers' true preferences.

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<sup>16</sup> EA web page <http://www.ea.govt.nz/operations/distribution/distributors/>.

15. The changes to IM in 2016 did not consider in any detail and hence implement MEUG's suggested alternatives to improve CPP consumer consultation processes, ie:
  - A separate verifier with expertise in public consultation;
  - A prescribed tabular format;
  - A prescribed list of parties that must be consulted.
16. MEUG suggests our submissions on August 2016 and the possible solutions proposed are still worth considering alongside suggestions such as a consumer panel mentioned in Table G, Appendix A of the CC open-letter.

#### **Topic h, Verification**

17. A CPP application is a complex transaction between an EDB applicant, the Commerce Commission and customers and consumers of an EDB's regulated line services. The transaction is complex because it deals in intricate technical and regulatory design issues. The Commission and more so customers and consumers having asymmetric deficiencies in resources and information compared to an EDB applicant. Another dimension of complexity is the measure of success, being the long-term benefit of consumers, because it has a long-term intergenerational perspective and effects on individual consumers can be quite different from the average effect on all consumers connected to an EDB.
18. EDB and the Commission view use of an external verifier as a success to lower transaction costs to meet the tight application processing deadlines on the Commission. We think that may have come at the expense of introducing a fourth party to the transaction, being the verifier, that has no current or long-term relationship with customers and consumers. While subjective, we think introducing a verifier has weakened the subtle but important pressure customers and consumers exert directly onto EDB and the Commission over time for improvements in efficiency and effectiveness.
19. For us the rationale and role of the verifier is still an open question. We have no specific suggestions to improve how a verifier works because the larger question of whether the benefits a verifier adds offsets downsides should be considered first. Hence for MEUG our interest is in understanding:
  - If one of the reasons for using a verifier was to meet onerous CPP timetable requirements, then a solution to consider would be extending the timeline the Commission's timeline.<sup>4</sup>
  - Have there been lessons from similar overseas jurisdictions on the use of verifiers?

#### **Topic i, Defining and applying proportionate scrutiny**

20. The 2016 IM inclusion of proportionate scrutiny has not been sufficiently tested to date to warrant changes; though with experience with further CPP applications the case for a review may become evident.

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<sup>4</sup> As an aside MEUG will be monitoring the current use of a verifier for the current Transpower IPP proposal for RCP3. The concerns noted in this submission of a verifier being a fourth party in a complex transaction with no direct short or long-term relationship with customers and consumers also applies to the IPP reset process.

**Next steps**

21. We look forward to viewing the submissions of other parties.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. Matthes', with a long horizontal stroke extending to the right.

Ralph Matthes  
Executive Director