



Submission on
Input Methodologies Review
Draft Decisions

4 August 2016

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1. Introduction

1. Thank you for the opportunity to comment on the Commerce Commission's (**Commission**) draft decisions in relation to the review of the input methodologies (**IMs**).

Format of submission

2. This submission responds to:
 - 2.1 the Commission's consolidated package of draft decision papers dated 16 June 2016; and
 - 2.2 the Commission's report on the IMs review dated 22 June 2016.
3. This submission also incorporates the following expert report prepared for Powerco and annexed to this submission:
 - 3.1 HoustonKemp, "Issues raised by the Commerce Commission in its draft decision on cost of capital" (3 August 2016).
4. This submission does not discuss Powerco's views on the specific drafting changes to the IMs in any detail. We intend to address these substantively in our submission on the draft determinations due 18 August 2016.

Summary of Powerco’s views

5. The following table summarises Powerco’s views and sets out our recommended amendments.

Framework for the IM review	Powerco view	Recommendation
<p>The Commission has proposed changing the IMs only where the change appears likely to:</p> <ul style="list-style-type: none"> • better promote the Part 4 purpose; • better promote the purpose of IMs; and • significantly reduce compliance costs, other regulatory costs or complexity, without undermining the purposes of Part 4 and the IMs. <p>It notes three key economic principles relevant to the Part 4 regime:</p> <ul style="list-style-type: none"> • Real financial capital maintenance (FCM), that is, suppliers have an ex-ante expectation of maintaining their financial capital in real terms; • Risk is allocated to the parties who are best placed to manage the risk; and 	<p>We support the ENA’s submission on the Commission’s framework.</p> <p>While the framework paper provides useful information and description of the IM decision-making process, more could be done to give certainty and confidence to EDBs.</p> <p>This could be achieved by the Commission committing strongly to the economic principles underpinning the IMs.</p>	<ul style="list-style-type: none"> • The final determinations should include a clear restatement of the policy intent underlying the IMs. • Changes to the IMs should be consistent with the core economic principles, i.e. the expectation that EDBs will earn at least normal returns over an asset’s lifetime. • The Commission should confirm that any substantive changes to the IMs outside the seven year review period will only be made where a clear materiality threshold is met. For instance, it may be appropriate and materially relevant to review the IMs’ approach to emerging technologies. • The Commission should clarify the status of the 2010 Reasons Paper in light of its final Reasons Paper, particularly when there are inconsistencies.

<ul style="list-style-type: none"> FCM is applied recognising the asymmetric consequences for consumers of over-investment versus under-investment. 		
Topic 1: Form of control	Powerco view	Recommendation
<p>The Commission proposes changing the form of control for EDBs from a WAPC to a pure revenue cap. The revenue cap has various features to prevent price shocks, such as a cap on voluntary underspending, and a cap on the amount that can be washed up following a catastrophic event. For GDBs, the Commission is retaining the WAPC.</p> <p>The pure revenue cap is designed to remove quantity forecasting risks associated with the WAPC, and will incentivise efficient pricing and investment in energy efficiency.</p> <p>The Commission proposes making no change to the asset beta as a result of changing the form of control.</p> <p>The Commission has clarified its approach to RAB indexation as offering an ex-ante expectation of a real return (real FCM), and delivering ex-post real return. This protects both consumers and suppliers from</p>	<p>Powerco accepts revenue control for EDBs, and strongly agrees that there is no link between the form of control and the asset beta.</p> <p>The Commission’s rationale for moving from a WAPC to a pure revenue cap for EDBs is sound. We consider the EA’s concerns for moving to a pure revenue cap are overstated.</p> <p>In line with the ENA, we do not support the proposed cap on the wash-up amount for EDBs that have experienced a catastrophic event.</p> <p>Likewise, the proposed cap on voluntary undercharging could create a “use it or lose it” approach to pricing, which may not be in the best interests of consumers.</p> <p>We support the Commission’s proposal to continue with the WAPC form of control for GDBs.</p> <p>Powerco welcomes the Commission’s clarification of the policy intention behind the RAB indexation.</p>	<ul style="list-style-type: none"> The asset beta should remain unchanged. The catastrophic event restriction on wash-up should be removed. However, if it is retained, the Commission should specify the percentage of the X% allowable revenue in order for Powerco to be able to comment on its appropriateness. The Commission should hold off implementing the cap on voluntary undercharging, and instead revisit this issue during the next IM review. We consider the Commission should clarify that the RAB indexation regime offers a real return plus actual inflation, which would maintain financial capital in real terms.

inflation risk. It recommends no change to the current IMs.		
Topic 2: CPP requirements	Powerco view	Recommendation
<p>The Commission has amended the DPP and CPP regimes with the aim of reducing cost and complexity, and to improve the certainty provided by the IMs. It has relied on the “proportionate scrutiny” principle to design pragmatic, cost-effective mechanisms and systems for the DPP and CPP processes. These include the following:</p> <ul style="list-style-type: none"> • Various reopener provisions for DPPs and CPPs; • Allowing pass-through costs to be specified prior to forthcoming DPP period; • Allowing prudently incurred costs to be recovered from the time at which suppliers apply for a CPP; • Aligning the DPP and CPP WACC rates. <p>In line with its focus on the “proportionate scrutiny” principle, the Commission proposes to recalibrate the information, verification, audit, and consumer consultation</p>	<p>Powerco encourages the Commission’s efforts to employ the proportionate scrutiny principle in how it approaches the DPP and CPP regimes.</p> <p>We accept the expanded DPP reopeners, but note that our support of the Commission removing the CPRG reopener is contingent on the Commission changing the form of control to a pure revenue cap.</p> <p>We encourage the Commission to introduce a CPRG reopener for GDBs as a means of addressing the risk that exists under a WAPC of material under- and over-recovery of revenue due to CPRG forecasting errors.</p> <p>We consider it appropriate to allow suppliers to recover prudently incurred costs 12 to 24 months prior to a CPP application being filed with the Commission.</p> <p>Aligning the WACC for both DPPs and CPPs is eminently sensible, and Powerco strongly supports this proposal.</p> <p>While we endorse the majority of the amendments to the CPP process, at this stage we mention the following points:</p> <ul style="list-style-type: none"> • The requirement that CPP applicants produce a deliverability plan is a practical suggestion, and something that should be verified; however, we do not agree that this should form part of the initial 	<ul style="list-style-type: none"> • If the Commission retains the WAPC, then it should also retain the CPRG DPP reopener. • The Commission should introduce a CPRG reopener for GDBs. • The IMs should provide for the recovery of prudently incurred costs 12 to 24 months prior to a CPP application being filed with the Commission. • The Commission should align the DPP and CPP WACC. • The Commission should reassess the scope of the verifier’s role. In particular, it should limit the maximum number of projects the verifier must assess to 10 projects. • The requirement for verifiers to assess the reasonableness of past decisions relating to quality should be removed. • The proposed deliverability plan should not form part of the CPP proposal.

<p>requirements for CPP applications. These amendments are designed to reduce cost and complexity, and increase certainty in the IMs regime.</p> <p>A high-level diagram of the proposed CPP application process has been included as part of the Commission's report.</p>	<p>application.</p> <ul style="list-style-type: none"> • We endorse the modification and exemption mechanism. • We support the Commission's aim of increasing the clarity of the verifier's role. However, we note that the verifier's involvement in the process needs to be iterative, and as such they should participate throughout the process as opposed to on an ad hoc basis. • While we note the Commission has provided verifiers with additional flexibility in the number of projects they assess, we consider that the maximum number of projects should be limited to 10, as opposed to 20. • We do not consider it appropriate to require the verifier to assess the reasonableness of historical decisions relating to quality. • The Commission's proposal that CPP applicants provide a high-level summary is sound in theory, but in practice it forms another process for applicants to spend time and resources drafting. We think the Commission could achieve the same effect by other, less resource-intensive means. It is also appropriate for the verifier to be involved in this process. • In line with the ENA's submission, we agree that it is not appropriate for consumer consultation to include consultation on price/quality trade-offs for <i>all</i> 	<ul style="list-style-type: none"> • We consider the Commission's proposal that applicants produce a high-level summary of their CPP application should instead be replaced with a requirement for applicants and the verifier to meet with the Commission to discuss the application. • Consumer consultation should focus on alternative investment options which relate to the key reasons for the CPP application. • We recommend the Commission reconsider its CPP application diagram in light of the upcoming CPP window in 2017.
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	<p>investment options.</p> <p>The Commission's indicative CPP application diagram presents serious timing problems for suppliers seeking to apply in the next CPP window.</p> <p>Powerco intends to provide substantive comments on the draft IMs determinations in its submission due 18 August 2016.</p>	
Topic 3: Emerging technologies	Powerco view	Recommendation
<p>The Commission recognises that there is an increasing likelihood that emerging technologies will have a material impact on the energy sector.</p> <p>It acknowledges that, at this stage, it is difficult to determine what the impact of these emerging technologies will be on EDBs, and how they will respond to the associated challenges and opportunities.</p> <p>In light of the potential implications of upcoming technology changes, the Commission proposes the following amendments:</p> <ul style="list-style-type: none"> • A mechanism to allow EDBs to reduce asset lives by 15%; • Requiring EDBs to disclose information in relation to the 	<p>We consider the Commission is taking the right stance in its consideration of emerging technologies, specifically:</p> <ul style="list-style-type: none"> • focusing on its purpose of promoting the long-term interests of consumers of regulated services; • maintaining or enhancing the flexibility that the IMs give businesses to respond and adapt; • investing in understanding potential emerging technology-related developments; and • encouraging open debate and dissemination of knowledge in the sector. <p>The Commission's proposal to allow asset lives to be reduced by 15% is a potentially valuable solution to reduce the risk of partial capital recovery. However, the scope of this adjustment factor is currently unclear (for instance, would this apply on the basis of asset class, asset location, etc?). We submit that the Commission could helpfully clarify the implementation of this</p>	<ul style="list-style-type: none"> • We recommend the Commission retains the mechanism to reduce asset lives, but should further clarify the implementation of this mechanism. • The Commission should not ring-fence EDBs from investing in emerging technologies. • The ACAM threshold should not be reduced. • The Commission should clarify its approach in relation to customer contributions • CFOs should not be required to make declarations regarding the use of proxy indicators. • Given the changing face of emerging technologies and how they might affect the energy sector,

<p>rationale for the use and choice of proxy cost allocators;</p> <ul style="list-style-type: none"> Reducing the revenue materiality threshold at which EDBs can apply ACAM from 20% to 10%. 	<p>proposal.</p> <p>In line with the ENA’s submission, we do not support the ERANZ’s proposal to ring-fence EDB investments in emerging technologies. We agree with the Commission that the current definition of the regulated service does not constrain the technology that an EDB can use or the way an EDB chooses to provide the regulated service.</p> <p>The Commission’s rationale behind the proposal to reduce the 20% ACAM threshold to 10% seems unclear, and may not be based on sound assumptions.</p> <p>Likewise, the distinction between regulated and unregulated services, as well as its treatment of customer contributions, could both do with further explanation.</p> <p>The requirement that CFOs make a declaration regarding the use of proxy allocators with each disclosure seems unnecessary and unduly onerous, given directors will have already have certified this.</p>	<p>we recommend the Commission consider whether a mid-period review of emerging technologies would be appropriate.</p>
<p>Topic 4: Cost of capital</p>	<p>Powerco view</p>	<p>Recommendation</p>
<p>Powerco has limited its comments to the Commission’s proposals to:</p> <ul style="list-style-type: none"> reduce the allowance for debt issuance costs; remove the adjustment to asset beta for GPBs; reduce the notional leverage to 	<p><i>Debt issuance costs</i></p> <p>Powerco disagrees with the Commission’s proposed reduction in the allowance for debt issuance costs. We think the Commission should allow the recovery of all costs that a supplier acting consistently with the Commission’s financing assumptions would efficiently incur. This includes, for example, the costs associated with maintaining a BBB+ credit rating. In addition, there</p>	<p><i>Debt issuance costs</i></p> <p>The Commission should revisit its assessment of debt issuance costs in light of the observations in Powerco’s submission and the enclosed report from HoustonKemp.</p> <p>The Commission should set an allowance for debt issuance costs that</p>

<p>41%; and</p> <ul style="list-style-type: none"> align the DPP and CPP WACCs. 	<p>are a number of other costs that the Commission has failed to account for.</p> <p>We think that the survey the Commission has relied upon provided an insufficient basis to support the Commission's conclusions. It is apparent that the Commission's analysis understates the actual costs of raising debt.</p> <p>Finally, there are a number of financing costs that the Commission has not provided for in its assessment notwithstanding they are efficiently incurred. For example, the allowance for debt issuance costs should include the costs of maintaining headroom and cost of carry.</p> <p>Asset beta</p> <p>Our view, supported by HoustonKemp's analysis, is that the Commission's reasons for rejecting HoustonKemp's analysis do not support the Commission's conclusion. In our view, the empirical evidence supports the view that the asset beta adjustment for GPBs should remain.</p> <p>Leverage</p> <p>The Commission's proposal to adjust notional leverage is unnecessary tinkering and, we think, contrary to the approach to this review signalled by the Commission at the outset of the process.</p> <p>WACC alignment</p> <p>We agree with the Commission's definition of the problem and support the proposed solution.</p>	<p>allows suppliers acting consistently with the Commission's financing assumptions to recover efficiently incurred costs. That would include costs of maintaining a BBB+ credit rating, headroom and cost of carry.</p> <p>The Commission should re-open its survey and seek further and better information on actual debt issuance costs to inform its analysis.</p> <p>Asset beta</p> <p>The Commission should retain the adjustment to the asset beta for GPBs in light of the comments in this submission and the enclosed report from HoustonKemp.</p> <p>Leverage</p> <p>The Commission should retain the existing notional leverage parameter.</p> <p>WACC alignment</p> <p>The Commission should proceed to implement its proposed solution.</p>
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Topic 7: Related party transactions	Powerco view	Recommendation
<p>The Commission’s policy intent behind its approach to related party transactions is to ensure such arrangements cannot be manipulated by regulated suppliers to allow them to extract excessive profits.</p> <p>It also notes that the problem definition (if any) is currently incomplete, and intends to update interested parties later this year.</p> <p>Unlike its other Topic Papers, Topic Paper 7 poses questions for submitters to consider in order to assist the Commission’s understanding in relation to related party transactions.</p>	<p>We support the ENA’s submission on this matter.</p> <p>In particular, we encourage the Commission to consider the regulation of related party transactions in a principled way, bearing in mind the overall policy intent of the IMs review, which is to:</p> <ul style="list-style-type: none"> • better promote the Part 4 purpose; • better promote the purpose of IMs; and • significantly reduce compliance costs, other regulatory costs or complexity, without undermining the purposes of Part 4 and the IMs. <p>We consider the Commission should carefully consider the relationship between related party trends and whether there is an actual, identifiable problem. This is not to say that we consider that a problem exists or otherwise; rather, we caution against the Commission attempting to fix the regulations for related party transactions if they are not broken.</p>	<ul style="list-style-type: none"> • The Commission should ensure that it fully understands the drivers behind the emerging trends in related party transactions before proposing solutions. • To that end, we recommend a sensible first step would be to hold industry workshops to better understand whether there is in fact an issue.

2. Framework for the IM review

2.1. Summary

6. Powerco commends the Commission for setting out its approach to the IMs review in its framework paper. We consider that this increases the transparency of the process, and helps to properly target areas for improvement in what is a very large review process. Having a framework paper allows submitters to address issues on their underlying policies, as well as helping the Commission to reach principled decisions.
7. To that end, we endorse the ENA's submission on the framework paper.¹ As a general principle we agree that focusing on the core economic principles behind the IMs regime are a sound starting point for this review; the most material principle being that an asset should earn at least normal returns over its lifetime. Any change to (or departure from) the core economic principles should have a compelling evidentiary basis, and a strong economic justification.²
8. As the Commission recognises in its framework paper, it has only attempted to fix those IMs where there are problems, or to achieve a significantly better outcome without increasing cost or complexity.³ In principle, we agree with this approach. Further, any changes to the IMs should be linked back to the underlying policy intent, with the rationale for any change being clearly articulated by the Commission.
9. This policy applies both to changes made in this review process, as well as any changes the Commission proposes outside the seven year review period. More generally, we submit that the Commission should confirm that any substantive changes to the IMs outside the seven year review period will only be made where a clear materiality threshold is met.
10. That said, we agree with the ENA that the IMs review would benefit from a statement upfront outlining the underlying policy in real terms. At present, the policy intent is stated as being "what was the IM attempting to achieve, either on its own or as part of the IMs as a package".⁴ However, the policy intent must go beyond this. We think the finalised IMs determinations should include a clear restatement upfront of what it is that the IMs are aiming to achieve.⁵
11. We note that some of the topic papers produced by the Commission contain policies in relation to specific issues (such as the Commission's approach to CPP applications and emerging technologies, etc). These individual policies should be linked back to the overarching policy intent, or alternatively the Commission should explain clearly why the policy promotes the overall purpose of Part 4 and the IMs, without increasing the cost and/or complexity of the regulatory regime.
12. Likewise, we consider that any inconsistencies between the Commission's 2010 Reasons Paper and its final determinations should be directly addressed and clarified as part of this review process.

¹ ENA, "Input Methodologies Review Draft Decisions: Framework for the IM review" (4 August 2016).

² ENA, "Input Methodologies Review Draft Decisions: Framework for the IM review" (4 August 2016), at p 5.

³ Commerce Commission, "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016), at [X13] – [X14].

⁴ Commerce Commission, "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016), at [79].

⁵ ENA, "Input Methodologies Review Draft Decisions: Framework for the IM review" (4 August 2016), at [12].

13. In Powerco's opinion, certainty and flexibility are both important (yet sometimes conflicting) regulatory outcomes. To the extent that the IMs amount to a regulatory compact is, in our view, a moot point: our ideal outcome for this review is a regulatory regime that ensures certain returns for investors in regulated industries, as well as providing sufficient flexibility so as to allow regulated suppliers to serve customers in the face of change and development (i.e. catastrophic events and emerging technologies).
14. We provide comments on the individual topic papers below.

3. Topic 1: Form of control and RAB indexation

3.1. Summary

15. Powerco agrees with the Commission that there are strong policy reasons to change the form of control for EDBs from Weighted Average Price Cap (**WAPC**) to pure revenue control. The Electricity Authority's (**EA**) concerns around this matter are, we think, overstated, and are unlikely to materialise.
16. We consider that the Commission's decision on the appropriate form of control for EDBs is intrinsically linked with the Commission's decision to maintain the WACC at its current level. These decisions are inherently interconnected.
17. Powerco generally accepts the proposed design of the pure revenue cap. We have provided some suggested amendments are listed below, particularly in relation to the cap on wash-up for catastrophic events.
18. We support the Commission's proposal to continue with the WAPC form of control for GDBs, and the clarifications made to its approach to RAB indexation.

3.2. Form of control for EDBs

Proposal

19. The Commission proposes to change the form of control for EDBs. The current form of control is WAPC. The proposal is that going forward EDBs would be subject to a pure revenue cap. By "pure" revenue cap the Commission means a revenue cap that enables EDBs to earn the allowable revenue.⁶
20. Assuming (as the Commission suggests) the form of control for EDBs is changed in line with the method set out in the gas DPP implementation paper,⁷ this is likely to be implemented when the electricity DPP is next reset, i.e. in 2020.⁸ This change to the form of control will take immediate effect for upcoming CPP applications.⁹
21. Powerco supports the change of form of control to a pure revenue cap, for the reasons covered by the Commission. These are discussed below.

Reasons for the change

22. The Commission compares WAPC and pure revenue control regulation across five dimensions:
 - 22.1 Incentives for efficient expenditure¹⁰
 - 22.2 Incentives for energy efficiency and demand-side management (**DSM**)¹¹

⁶ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [13].

⁷ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [99].

⁸ Commerce Commission, "Default price-quality paths for gas pipeline services from 1 October 2017: Implementing matters arising from proposed input methodologies changes" (28 June 2016), at [23].

⁹ Commerce Commission, "Input methodologies review draft decisions: Report on the IM review" (22 June 2016), at [30.3].

¹⁰ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [31] – [39], [55] – [68].

22.3 Incentives for pricing efficiency and tariff restructuring¹²

22.4 Connection incentives¹³

22.5 Price stability.¹⁴

23. Each of these is discussed below.

Incentives for efficient expenditure

24. The essential issue here is that WAPC leaves the EDB exposed to regulatory quantity forecasting risk, and this creates incentives to under-invest. This is due to the variability of revenue under WAPC – either resulting in loss or gain – which inevitably leads EDBs to take a conservative approach to investment. Emerging technologies, technology disruption, changes to overall demand, and changes to demand patterns will make quantity forecasting in the future a degree of magnitude more difficult for the Commission than it has been in the past. The Commission identifies this issue as the most significant problem raised in respect of WAPC.¹⁵
25. Powerco agrees this is a significant problem. The Commission’s analysis shows that demand forecasting is difficult in the current environment, and EDBs are exposed to the risk that actual demand will differ materially from the forecast determined by the Commission to set WAPC.¹⁶ This exposes EDBs to the risk that profitability differs significantly from the Commission’s and investors’ expectations. In these circumstances, the risks attached to the regulatory demand forecasts create an incentive to invest less than would be optimal, and less than is in the long-term interests of consumers.
26. As submitted by the ENA, this situation is only going to get more difficult.¹⁷ The impact of emerging technologies on demand volatility and demand patterns will undoubtedly make the regulator’s job of setting a demand forecast for a WAPC harder, and the risk to investment incentives will increase.
27. A change to a pure revenue cap removes this form of risk, so that it is not borne by the EDB. As noted by the Commission there is a trade-off, as the change will also shift the risk of demand volatility during the regulatory period from the EDB to consumers. However the positive impact for consumers of removing the incentive to under-invest is likely to be much more significant.¹⁸

¹¹ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [40] – [42], [69] – [70].

¹² Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [43] – [48], [71] – [86].

¹³ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [87] – [93].

¹⁴ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [94] – [96].

¹⁵ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [39].

¹⁶ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [59] – [68].

¹⁷ ENA, “Response to the Commerce Commission’s input methodologies review paper” (21 August 2015), at [85]; discussed at [36].

¹⁸ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [58].

Incentives for energy efficiency and DSM

28. WAPC severely restricts the incentives of an EDB to innovate and explore energy efficiency and demand-side management initiatives. WAPC essentially penalises an EDB for lowering volume, and this is a very strong effect to overcome. The existing energy efficiency allowance mechanism is probably the best that can be fashioned within a WAPC framework, but it has all of the cost and uncertainty of a regulatory approval process and it does not address the problem at the level of correcting incentives.
29. Powerco agrees that if the sector is serious about creating incentives for energy efficiency and DSM then a move to a pure revenue cap is required.

Incentives for pricing efficiency and tariff restructuring

30. One thing that stakeholders appear to agree on is that emerging technologies will provide opportunities for consumers, and this is likely to make it more important that EDBs are open to considering more innovative and cost-effective pricing structures. Emerging technologies will potentially change the way customers use the network and drive network investment requirements, and change the way customers respond to traditional price structures. The EA suggests that the benefits of improving distribution price structures over the next 25 years may be as much as \$1 billion.¹⁹
31. Powerco agrees with the Commission that WAPC currently acts as a strong dis-incentive for an EDB to innovate with its price structure. The customer and revenue reactions to a new price structure are difficult to predict, and this will be more so as emerging technologies are adopted by customers. WAPC puts that revenue risk on the EDB, which imposes a strong incentive to delay innovation.
32. A move to a pure revenue cap will change these incentives. The EDB will have revenue certainty, and from that position can develop price structures and new technologies to optimise use of the network, investment and operating expenditure. This will be in the long-term interests of consumers.
33. As the Commission notes, in theory WAPC creates the appropriate incentives on an EDB to set the efficient price structure. However the real world is departing from theory in a number of ways. First, as noted above, when the market is not static, and the task is for the EDB to discover the efficient price structure by experimentation in the face of volatility, WAPC actually creates a strong incentive to delay.
34. Second, as noted by the Australian Energy Regulator (**AER**), the theoretical advantages of WAPC rely on some assumptions that do not hold in the real world: distributors having the necessary information, expertise and independence to act with certainty; EDB tariffs being reflected in retailer tariffs to consumers; and consumers being fully informed about prices and how to respond.²⁰
35. We agree that in practice, the pure revenue cap is more likely to result in EDBs innovating and discovering efficient price tariffs that best suit the challenges ahead.
36. We note that the EA has not reached a conclusive view on the impact that a pure revenue cap might have on the electricity industry. However, it holds reservations that this form of control might reduce distributors' incentives to adopt efficient distribution pricing structures.

¹⁹ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [80].

²⁰ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [76].

37. Specifically, the EA has made the following points:²¹
- 37.1 In the face of emerging technologies, the revenue cap could reduce incentives for distributors to change their pricing structures to be more efficient and less consumption-based.
 - 37.2 Based on economic theory, a revenue cap could provide incentives for distributors to set inefficiently high prices for price-responsive services and/or customers, in an attempt to drive down costs and increase profit.
 - 37.3 A revenue cap might create an incentive for distributors to over-price and defer investment inefficiently. The EA considers such a strategy might become more feasible with the increasing deployment of smarter network infrastructure, which increases the precision of which consumer usage is monitored.
 - 37.4 Based on the EA's concerns around inefficiencies arising from a revenue cap, it may result in the EA increasing its scrutiny of distributors. This, in itself, is an inefficient outcome.
 - 37.5 Changes to the electricity industry are likely to make it easier for distributors to change pricing structures under WAPC. These changes include the increasing prevalence of smart meters, the EA's interpretation of the Electricity (Low Fixed Charge Tariff Options for Domestic Consumers) Regulations 2004, and the growth of alternative energy sources such as solar panels and batteries.
38. In our view, these concerns are overstated.
39. As regards the EA's concerns around inefficient pricing structures, we outlined our views on the impact of evolving technologies for pricing of distribution services during the EA's submission process.²² That submission set out that EDBs only play a bit part in ensuring efficient pricing outcomes for consumers, and that there are a range of other factors (including electricity retail businesses, consumer preferences, and regulatory restrictions) that must also be considered. These factors limit the degree to which EDBs are able to amend their pricing structures under WAPC.
40. For instance, until recently, cost-reflective pricing for residential distribution services has not been possible due to metering restrictions. This problem is being gradually overcome with the introduction of smart meters. In this instance, the delay in moving towards cost-reflective pricing has not been caused by action (or inaction) from EDBs. We consider investment in new technologies like smart meters will not be affected by adopting a revenue cap.
41. Indeed, there is research suggesting that consumers will choose simple flat-rate tariffs over all forms of cost-reflective pricing, even if this means they will pay more. The research notes "well-known human biases *against* complexity, and *in favour* of familiarity and certainty",²³ and "the greatest barrier to the uptake of cost-reflective pricing appears to be consumers' aversion to making *any* kind of choice".²⁴ This being the case, if EDBs move

²¹ Electricity Authority, "Possible implications for efficient distribution pricing of a decision to change the form of control for electricity distribution businesses" (30 May 2016).

²² Powerco, "RE: Implications of evolving technologies for pricing of distribution services" (2 February 2016).

²³ Stenner, K., Frederiks, E., Hobman, E.V., Mickle, S. (2015) *Australian Consumers' Likely Response to Cost-Reflective Electricity Pricing*, CSIRO, Australia, at p 35.

²⁴ *Ibid*, p 37.

towards cost-reflective pricing, retailers are likely to retain the same flat-rate model and the benefits may not flow through to the end consumer in the way intended.

42. We support the comments made by the ENA in its response to the EA's submission to the Commission.²⁵ In addition, HoustonKemp's analysis of the implications of the form of control notes the following:²⁶

Although there are some theoretical reasons to expect that a WAPC might give rise to more efficient pricing for electricity distribution services, other evidence points in the opposite direction. Of particular relevance to this opinion is:

- empirical evidence from Australia suggests that, in practice, these theoretical benefits have not been achieved and that other, less desirable, behaviours are promoted by a WAPC; and
- a revenue cap, combined with regulatory pricing principles, may be capable of promoting efficient pricing.

This view aligns with the Australian experience of applying WAPCs to EDBs, where the AER recently changed to a revenue cap form of control from a WAPC for Victorian and New South Wales EDBs, and the Australian Energy Market Commission (AEMC) recently amended the national electricity rules to promote more efficient pricing practices by EDBs.

Under a revenue cap, the risks of forecast error are eliminated and there is a greater ability for businesses to innovate with pricing. Combined with regulatory principles to guide pricing objectives, a revenue cap may still be able to provide for efficient price structures.

43. In our opinion, the balance of these considerations, and lessons from the Australian experience, suggests that it is open to the Commission to consider that incentives for efficient pricing may not be. For these reasons, we disagree with the EA's view and support the Commission's proposed change to a pure revenue cap.

Connection incentives

44. Powerco agrees with the Commission that in practice a pure revenue cap will not alter an EDB's incentives to connect new customers and maintain connection growth. There are incentives on an EDB to maintain connection growth, including customer satisfaction and loyalty, the EDB's reputation in the region, network planning and network efficiency, and the addition of capital investment in the regulatory asset base (**RAB**).
45. The Commission turned its mind to whether extra revenues should be permitted under the price cap in the event of a large and unforeseen spike in new connections, but considered suppliers could manage such an event through their capital contributions policies. However, the amounts would be netted off the RAB.²⁷
46. Powerco supports the Commission's proposal at this stage. Should any issues arise in future regarding the lack of connection incentives, we will provide the Commission with our views at that time.
47. The Commission is also proposing to increase its information disclosure requirements, requiring EDBs to publicly report on connections, for instance, number of connection

²⁵ ENA, "Input Methodologies Review Draft Decision: Form of control and RAB indexation" (4 August 2016), at [38] – [64].

²⁶ HoustonKemp, "Issues raised by the Commerce Commission in its draft decision" (3 August 2016), at p 21.

²⁷ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [90].

requests and timeliness of connections. This is designed to highlight EDBs' quality of service, and any issues arising with the connection process.²⁸

48. In line with the ENA's submission, we support this approach in principle, but encourage the Commission to ensure the information disclosure requirements are cost effective.²⁹

Price stability

49. In theory, a pure revenue cap exposes consumers to more pricing volatility during a regulated period (compared with the outcomes under WAPC) but less volatility between periods.³⁰ The Commission is proposing design features of the pure revenue cap that would regulate price volatility during the regulatory period.³¹ Powerco submits this is not a material consideration in the choice of form of control.

Design of the pure revenue cap

50. There are three design aspects of the proposed revenue cap mechanism:

- 50.1 Determining the allowable revenue³²
- 50.2 The basic wash up mechanism³³
- 50.3 Proposed constraints on the purity of the wash up mechanism.³⁴

Determining the allowable revenue

51. The Commission proposes that the allowable revenue for the first year of the regulatory period would be the function of:³⁵
- 51.1 building block costs for the regulatory period, inflated for forecast CPI-X for each year. This would be the maximum allowable revenue in that year as calculated in the financial model for the DPP, and is termed the "net allowable revenue";
 - 51.2 pass-through and recoverable costs;
 - 51.3 a capex wash-up adjustment to correct for any capex forecasting error in the previous period; and
 - 51.4 any drawdown of a wash up account (which is treated as another recoverable cost).

²⁸ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [93]

²⁹ ENA, "Input Methodologies Review Draft Decision: Form of control and RAB indexation" (4 August 2016), at [37].

³⁰ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [95].

³¹ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [112] – [139].

³² Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [101] – [105].

³³ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [106] – [111].

³⁴ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [112] – [139].

³⁵ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [101] – [102], and footnote 48.

52. EDBs are required to set “year ahead forecast” quantities for each tariff. Prices must be set by the EDB so that the EDB’s estimate of revenue – the sum of all prices multiplied by the EDB’s year ahead quantity forecast – is equal to or less than its allowable revenue.
53. Powerco supports the Commission’s proposal.

The basic wash-up mechanism

54. The wash-up mechanism will restore the EDB to the position it would have been in had the EDB’s year-ahead quantity forecast and the CPI forecast been made with perfect foresight, taking account of the time value of money.³⁶
55. The basic wash-up mechanism, subject to the constraints discussed below, accumulates:
 - 55.1 The difference between allowable revenue and revenue received, adjusted for CPI, pass through costs and recoverable costs (to isolate the effect of the quantity forecast error). The delay in information on actual revenues becoming available means this wash up is available to be drawn down on a two year delay; and
 - 55.2 The difference between forecast and actual CPI, so that suppliers and consumers are exposed to actual CPI. The delay in information on actual CPI becoming available means this wash-up is available to be drawn down on a two year delay.
56. Powerco supports the Commission’s proposal.

Proposed constraints on the wash-up mechanism

Constraint on average price increase

57. The Commission proposes to amend the IMs to create the option of the Commission including in a DPP or CPP determination a constraint on the EDB’s ability to increase its weighted average price from one year to the next (say, by no more than x%, with x to be specified in the DPP or CPP determination). The Commission expects this will be more relevant to GTBs, but will include the option for EDB regulation.³⁷ This is to enable the Commission to address the concern noted above that a revenue cap can result in greater price volatility during a regulatory period.
58. We broadly support the inclusion of price smoothing mechanisms, but agree with the ENA’s submission that the proposed price increase constraint is likely to be redundant if the cap and collar on the drawdown amount is implemented (discussed below).³⁸ In any case, if the constraint on average price increases is included, we believe that setting x% at greater than 10% will ensure a workable solution.
59. Powerco supports the Commission’s proposal, and notes that this only provides the option (as opposed to the mechanism) for the Commission to be able to constrain EDBs.

Cap and collar on drawdown amount

60. A further potential source of price volatility under a revenue cap is the discretion of the EDB to draw down large or small amounts from its wash-up account to recover in the year

³⁶ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [105].

³⁷ Commerce Commission, “Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (16 June 2016), at [113] – [116].

³⁸ ENA, “Input Methodologies Review Draft Decision: Form of control and RAB indexation” (4 August 2016), at [20] – [22].

ahead. For this reason the Commission is proposing to amend the IMs to create the option of the Commission including in a DPP or CPP determination a constraint on the EDB's ability to draw down amounts.

61. If a cap was specified in the DPP or CPP determination, it would be the largest possible positive amount that could be drawn down from the account (expressed as a % of net allowable revenue). A collar would be the largest possible negative amount that could be drawn down. The EDB would have discretion between the cap and the collar (and depending on the amount in the wash up account).
62. We support this proposal, and note that this only provides the option (as opposed to the mechanism) for the Commission to be able to apply the cap and collar.

Cap on accumulation of voluntary undercharging

63. A pure revenue cap creates the theoretical possibility of an EDB building up a large positive balance in its wash-up account by deliberately under-charging for a sustained period.
64. The Commission is proposing to amend the IMs to create the option of the Commission including in a DPP or CPP determination a constraint on the EDB's ability to build up such a balance. The amount voluntarily added to the wash-up account would be identified by comparing the allowable revenue (including the wash-up balance) and the forecast of revenue, both known at the start of the year when setting prices. This may be capped in the DPP or CPP determination. This feature may only apply to EDBs that meet certain ownership criteria.³⁹
65. In line with the ENA's submission,⁴⁰ we think that this mechanism risks creating a "use it or lose it" approach to pricing, which may not be in the best interests of consumers. It would be prudent for the Commission to hold off implementing this mechanism at present, and rather wait until the next IMs review to assess whether this cap is necessary.

Cap on wash-up amount

66. The Commission proposes to amend the IMs to create the option of the Commission including in a DPP or CPP determination a constraint on the overall wash-up amount. The draft decisions paper notes the cap would limit what could be recovered by suppliers through the wash-up mechanism,⁴¹ and so we assume that the cap – like the wash-up – would be calculated on an annual basis.
67. The intention is to implement the principle that both suppliers and consumers should share in the consequences of a major demand shock. For that reason, the Commission intends to set any constraint at a level that would only bind after a major demand shock, such as a catastrophic event.⁴²

³⁹ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [120].

⁴⁰ ENA, "Input Methodologies Review Draft Decision: Form of control and RAB indexation" (4 August 2016), at [23] – [28].

⁴¹ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [126].

⁴² Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [127].

68. Powerco supports the ENA's views on this matter, in that the proposed cap on the wash-up amount for EDBs that have experienced a catastrophic event is inconsistent with nature of a pure revenue cap.⁴³
69. However, in the event that this wash-up mechanism is retained in the Commission's final determination, the Commission should specify the percentage of the X% allowable revenue in order for Powerco to be able to consider whether it is appropriate.
70. In any case, we note that this only provides the option (as opposed to the mechanism) for the Commission to cap the wash-up amount following a catastrophic event.
71. Further, the Commission's proposal includes a requirement that each supplier maintains a wash-up account outlining:
- 71.1 the wash-up balance;
 - 71.2 the difference (if any) between a supplier's forecast of pass-through and recoverable costs and the costs actually incurred, taking account of the time value of money;
 - 71.3 amounts drawn down from the wash-up account (either positive or negative); and
 - 71.4 time value of money adjustments.
72. We have no issues with this proposal at this time. Should our views change, we will provide comments to the Commission in due course.

Ex-ante price path compliance checks

73. If a pure revenue cap is adopted for EDBs, the Commission proposes to change price path compliance from an ex-post to an ex-ante assessment.
74. From Powerco's perspective, we are comfortable operating under either arrangement. That said, we foresee some difficulties for the Commission if it moves to an ex-ante assessment. This is due to the number of EDBs that will need to be assessed and the potentially short window in which these assessments will need to be completed. The Commission should ensure that it has considered its resourcing availability before committing to an ex-ante assessment.

WACC

75. The Commission notes its view that a link could feasibly be made between its proposed decision on form of control and asset beta for the purposes of WACC. At paragraph 19 of the Topic 1 Paper the Commission states:

We do not propose making an adjustment to asset beta for EDBs or GPBs for regulatory differences. We consider that, although theoretically regulatory differences may have an effect on asset beta, we do not consider that there is sufficient empirical evidence to suggest that we should propose making an adjustment, or what that adjustment should be, at this point.

76. The Commission reiterates its views in the Topic 4 Paper, from paragraphs [268] – [330].
77. As the Commission is aware, Powerco:

⁴³ ENA, "Input Methodologies Review Draft Decision: Form of control and RAB indexation" (4 August 2016), at [29] – [32].

- 77.1 supports Dr Lally's recommendation that asset beta is not affected by the form of control;⁴⁴ and
- 77.2 agrees that an adjustment to beta cannot be supported by the empirical evidence.
78. The Commission's paragraph 19 can be read as leaving open the possibility of the Commission revisiting this issue in the future. Powerco submits that would be a serious error.
79. Specifically, it would be a serious error for the Commission to consult with the industry in this IMs review on a change of form of control proposed by the Commission (it was the Commission that put the change to revenue control on the agenda when it commenced the IMs review), on the basis that a change would not result in a change to asset beta, and then to subsequently reverse the Commission's position on beta. That would seriously undermine confidence in the consistency of the Commission and the predictability of its administration of the Part 4 regime.
80. From an EDB's perspective, the very real gains that could flow to consumers from a change to pure revenue control would nevertheless be outweighed by any downward adjustment to asset beta. Powerco's consideration of the Commission's proposal and support for the change in form of control is on the basis the Commission is not proposing that a change in form of control would result in a change in asset beta.
81. For these reasons Powerco urges the Commission to approach this decision on the form of control for EDBs on the basis that it is intrinsically linked to the decision it is making in this review on the lack of impact on asset beta. They are, in both process and substance terms, part of one decision.

3.3. Form of control for GDBs

82. Powerco supports the Commission's proposal to continue with the WAPC form of control for GDBs.
83. As confirmed by the Commission, the reasons for changing the form of control for EDBs are not present for GDBs. Specifically:
- 83.1 There are not the same significant concerns about the accuracy and impact of the regulatory forecast of quantity used to set the WAPC for GDBs. Powerco has suggested that where improvements could be made these might be developed via a working group (and this is noted by the Commission at paragraph 178);
- 83.2 There is not the same demand or expectation that GDBs would experiment to discover new price structures in response to future technology and demand disruption;
- 83.3 WAPC incentives to actively grow volumes are of additional importance in the gas distribution market, where gas is seen by consumers as a discretionary fuel.
84. The Commission does propose to amend WAPC for GDBs to adopt the pass-through balance approach for forecasts of pass-through and recoverable costs. The objective of the balance is to remove risk of under- (and over-)recovery of pass-through and recoverable costs – reflecting the fact that these amounts are outside the control of distributors.

⁴⁴ Powerco, "IM Review 2016: Submission on four emerging view papers" (29 February 2016), at [14].

85. In our view, adopting the pass-through balance approach is likely to add a good deal of unnecessary complexity, cost, and risk for GDBs when forecasting pass-through and recoverable costs. We also do not perceive a problem with the current forecasting system.
86. At present, GDBs' pass-through costs represent only a small percentage of total costs, and they are currently included on a largely historic basis. Powerco applies a cost of debt so as to minimise its loss due to timing of recoveries. This means the risk of under-recovery is low.
87. Changing the methodology has knock-on costs. For instance, GDBs must change their standards, procedures, and model of quantifying pass-through. As such, we consider the resulting benefit would need to be quite material to offset the cost/risk associated with change. And, in Powerco's experience, it recently found that complying with the pass-through balance requirements under the DPP for EDBs was an onerous task.
88. We consider the addition of a pass-through balance for GDBs will unduly complicate the existing methodology, for little benefit. In the interests of reducing regulatory complexity, we do not support this proposed amendment and prefer the status quo.

3.4. RAB indexation

89. The Commission clarifies in Topic Paper 1 its approach to inflation and financial capital maintenance (**FCM**). At a high level, the Commission explains that its approach is intended to result in:⁴⁵

...a revenue / price path that includes a real return on capital with the revaluation of the RAB providing the compensation for inflation over the period.

90. The Commission explains its price setting approach:⁴⁶
 - 90.1 WACC: use a nominal WACC (which inherently incorporates inflation expectations at the time it is calculated);
 - 90.2 Forecast RAB revaluations: forecast inflation for each year of the regulatory period, then annually revalue the RAB by the forecast inflation;
 - 90.3 Forecast revaluations as income: deduct the forecast annual RAB revaluation (based on forecast CPI) from the annual allowed revenue (i.e. revaluations treated as income). This ensures that EDBs are not compensated for inflation twice (i.e. once by the use of a nominal WACC, and twice by revaluing the RAB);
 - 90.4 RAB roll forward: under ID, the RAB is revalued using actual rather than forecast inflation. Therefore, at the time of the next price reset, opening RAB values have been maintained in real terms.
91. In our view, the Commission should clarify that the RAB indexation regime offers a real return plus actual inflation, which would maintain financial capital in real terms. However, in general terms Powerco supports the Commission's proposals.

⁴⁵ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [203].

⁴⁶ Commerce Commission, "Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), at [241].

4. Topic 2: CPP requirements

4.1. Summary

92. When reviewing the default / customised price-quality regime, the Commission considered in particular:
- 92.1 how DPPs and CPPs work together; and
 - 92.2 specific improvements to the CPP requirements.
93. Powerco endorses the Commission's approach to amending the CPP and DPP IMs, in particular, its focus on reducing cost and complexity, and increasing certainty for suppliers. We consider that adopting pragmatic and cost-effective policies will have positive effects that will flow on to consumers, therefore promoting the purpose of the Part 4 regime.
94. We consider the Commission has proposed sensible changes to the way in which the DPP and CPP work together, as well as the audit and consumer consultation requirements.
95. However, we suggest that the Commission broadens its proposal to allow CPP applicants to recover prudently incurred costs up to 24 months prior to submitting a CPP application. We think that such an approach would be consistent with achieving the best outcomes for consumers.
96. We also have some concerns around the proposed changes to the verification requirements and information requirements for CPP applications. As discussed above, we support the general approach to the amendments, but consider that some of the proposed changes may not have the intended effects of reducing cost and complexity, and/or increasing certainty. In particular, we consider the following features of the CPP process would benefit from reconsideration by the Commission:
- 96.1 Provision of a high-level CPP summary;
 - 96.2 Provision of a deliverability plan;
 - 96.3 The number of projects that a verifier may assess;
 - 96.4 The verifier's ability to assess the reasonableness of historical quality decision.
97. We discuss our views on these issues below.
98. The Commission summarised its proposed changes to the IMs in tables X1-X5. These are replicated below, with Powerco's high level response.
99. We also note that our response has not focused on the drafting amendments to the IMs determinations. We propose to provide our comments on the proposed drafting in our submission due 18 August 2016.

Proposed changes in relation to how DPP and CPP work together (Table X1)

Topic	Proposed change	Outcome of proposed change
Quality only CPP	Option for EDBs to apply for a quality-only CPP removed and replaced by a quality-only DPP reopener.	Cost and complexity – suppliers are able to apply for a variation to their quality standards without the full cost of the CPP process. This also accounts for practical difficulties in assessing and evaluating 'single-issue' CPPs.
Powerco response:	Powerco supports the addition of this reopener, and considers it rightly reserved for suppliers only. We have no strong preference between DPP reopeners and single issue CPPs, providing the mechanism suitably tailors the relevant price-quality path.	
Pass-through costs	Pass-through costs may be specified in advance for the forthcoming DPP period as part of the DPP reset process – no longer restricted to specifying these costs during the affected regulatory period.	Cost and complexity – allows a greater number of pass-through costs to be specified through a DPP or CPP determination where the cost is outside of the control of the supplier, instead of requiring a change to the IMs.
Powerco response	Powerco supports the inclusion of additional costs as part of the DPP reset process. We also query whether GIC fees could form part of these additional costs.	
Prudently incurred expenditure	Allowing the recovery of prudently incurred costs, in response to an urgent project, between when a CPP is applied for and determined.	Promotion of the purpose of Part 4 – creates incentives to invest where urgent work is needed while the Commission is assessing a CPP proposal.
Powerco response	Powerco considers that costs prudently incurred (as determined at the time a CPP is applied for) and consistent with a supplier's asset management plan should be able to be recovered 12 to 24 months prior to submitting a CPP application.	
CPP contingent projects	Allowing the CPP to be reopened for contingent and unforeseen projects, for EDBs and GDBs.	Promotion of the purpose of Part 4 – provides incentives for suppliers to innovate and invest by allowing a mechanism for the consideration of large incremental expenditure (to be approved where appropriate) in addition to the expenditure originally provided for in a CPP.

Powerco response	Powerco supports the Commission's proposed amendment.	
Difference in DPP and CPP WACC rates	A single WACC should apply to all suppliers on DPPs and CPPs for the duration of each DPP regulatory period.	Promotion of the purpose of Part 4 – removing the separate WACC for CPPs so we do not dis-incentivise CPPs where they are in the long-term benefit of consumers.
Powerco response	Powerco supports this proposal. Our views are covered under <i>Topic Paper 4: Cost of capital issues</i> .	

Proposed changes to information requirements for CPP applications (Table X2)

Topic	Proposed change	Outcome of proposed change
Modifications and exemptions	Exemption and modification provisions (completed November 2015 as part of IM review) will specify scale as an explicit consideration for the approval of exemption and modification requests. This change will also apply to GPBs.	Certainty – now clear that Commission considers scale an important consideration in allowing CPP applicants to reduce the cost of preparing CPP application by applying for modifications and exemptions to the existing requirements.
Powerco response:	Powerco supports the Commission's proposed amendment, but suggests that the Commission include some flexibility in the timing for when applicants may seek modifications and exemptions.	
Duplication	Removing the need to duplicate information between documents, by aligning Schedules D and E with the relevant information disclosure requirements.	Cost and complexity – applicants able to rely more on already existing information when making a CPP proposal.
Powerco response	Powerco supports the Commission's proposed amendments. Further comments on the Commission's proposed drafting will be provided in our submission on 18 August 2016.	
Deliverability	Including new requirements for a deliverability plan for the proposed expenditure; and improving the way in which applicants demonstrate the deliverability of their proposed expenditure with existing requirements.	Certainty – deliverability expectations now clearer for applicants upfront.

Powerco response	Powerco supports the view that the Commission should consider the deliverability of the proposed expenditure. However, we question the need for a specific requirement that an applicant must produce a separate plan at the outset. It may become clear as the CPP process progresses that the applicant requires modifications and exemptions, which may feed into a deliverability plan being created at a later stage.	
Asset disaggregation	Simplifying the requirement for forecasting capex projects disaggregated by asset type.	Cost and complexity – applicants not required to spend time allocating asset forecasts at a more detailed level.
Powerco response	Powerco supports the Commission’s initiatives to make the CPP process less onerous on applicants. Further comments on the Commission’s proposed drafting will be provided in our submission on 18 August 2016.	
Related party transactions and capital contributions	Changing the requirements for related party transactions and capital contributions to an aggregate level of capex, rather than a project level.	Cost and complexity – applicants not required to spend time allocating related party transactions at a more detailed level.
Powerco response	Powerco considers the Commission’s proposed amendments reflect the information requirements in the ID. Further comments on the Commission’s proposed drafting will be provided in our submission on 18 August 2016.	
Disaggregation of service categories	Removing the requirement for expenditure to be disaggregated by service categories.	Cost and complexity – applicants not required to spend time allocating expenditure at a more detailed level.
Powerco response	Powerco supports the Commission’s efforts to reduce and simplify the volumes of information sought through the CPP process. Further comments on the Commission’s proposed drafting will be provided in our submission on 18 August 2016.	

Proposed changes to verification requirements (Table X3)

Topic	Proposed change	Outcome of proposed change
Role and purpose	Adding a new section to the verifier’s terms of reference in Schedule G of the IMs that defines the	Certainty – both applicant and verifier have more information upfront on the verifier's role in the verification process.

	verifier's role, purpose, and obligations.	
Powerco response:	We support the Commission's efforts to provide increased certainty in the verifier's role. In line with the ENA's view, we recommend the verifier's terms of reference be amended to define the verifier's role, purpose and obligations, with additional amendments in order to remove ambiguity and better align with the remainder of the CPP IMs.	
High level summary	Requiring the CPP applicant to provide us with a high level summary of their application by the time the verifier is engaged.	Cost and complexity – contributes towards a more efficient process by allowing us information upfront to better prepare for the type of CPP proposal being developed.
Powerco response	In line with the ENA's submission, we recommend that the Commission removes the requirement for a high level summary, as it adds undue cost and complexity, and exposes the applicant to Commission scrutiny too early. We suggest that this requirement is replaced by a meeting with the Commission to discuss the CPP proposal.	
Communication protocol	Amending the tripartite deed requirements in Schedule F5 to include a communication protocol that sets out the roles and obligations of the parties during the verification process regarding communication, and to allow meeting minutes to be used as the evidential basis for any verifier technical opinions.	Certainty – provides certainty to applicant that they can have confidence that they can engage openly with knowledge Commission will not view draft material.
Powerco response	Powerco supports the Commission's proposal.	
Flexibility in number of projects assessed	Allowing the verifier greater flexibility in the number of projects that are verified, the extent of their verification, and the content of the CPP proposal that we review.	Cost and complexity – applicants not required to allocate expenditure into a specific number of projects where they may not have them.
Powerco response	In principle, Powerco supports greater flexibility being given to verifiers. However, we consider that the verifier should be required to verify a maximum of 10 projects, as opposed to the suggested 20. In line with the ENA's submission, we also recommend that the Commission improves the associated draft guidance.	
Non-standard depreciation	Removing the obligation for the verifier to consider nonstandard depreciation.	Cost and complexity – verifier no longer required to assess an area where its expert opinion adds little value.

Powerco response	Powerco supports this proposal.	
Removal of independent engineer	Removing requirement for an independent engineer, and allowing suppliers to prepare the quality standard variation report themselves, subject to verification by the verifier (EDBs only).	Cost and complexity – removing need for separate roles where a verifier is likely to be able to provide an appropriate opinion on any quality standard variation.
Powerco response	Powerco supports this proposal.	

Proposed changes to audit requirements (Table X4)

Topic	Proposed change	Outcome of proposed change
Audit report	Clarifying the requirement for the auditor to provide a report setting out the auditor’s opinion on specified matters.	Certainty – now clear the auditor must provide a report as part of the audit process where previous this was ambiguous.
Powerco response:	Powerco supports the Commission’s proposed amendments.	
Clarified role – historical v forecast data	Differentiating the role of the auditor with respect to historical financial information and forecast financial information.	Certainty – now clear the specific type of assurance the auditor is expected to provide in respect of different types of information.
Powerco response	Powerco supports the Commission’s proposed amendments.	
Spreadsheets	Removing ambiguity around quantitative information provided in spreadsheets.	Certainty – now clear the specific type of assurance the auditor is expected to provide in respect of different types of information.
Powerco response	Powerco supports the Commission’s proposed amendments.	
Clarified role –	Clarifying the requirement on the auditor to provide a	Certainty – the scope of audit requirements is now more clear.

proper records	view in respect of proper records being kept.
Powerco response	Powerco supports the Commission's proposed amendments.

Proposed changes to consumer consultation requirements (Table X5)

Topic	Proposed change	Outcome of proposed change
Price – quality impact of alternative investment options	Amending the consumer consultation IMs to require CPP applicants to notify consumers of the price and quality (EDBs) impact of any alternative investment options in their CPP proposal.	Certainty – applicants have more information upfront on our expectations for the consumer consultation process.
Powerco response:	Powerco supports the Commission's efforts to give greater clarity around its CPP consultation expectations, while also providing suppliers with flexibility to undertake consultation in the manner they consider appropriate. However, we agree with the ENA that consumer consultation should not include consultation on price/quality trade-offs for all alternative investment options. Rather it should focus on alternative investment options which relate to the key reasons for the CPP proposal.	
Verifier's view	In support of the change proposed above, we propose amending the verifier Terms of Reference in Schedule of the IMs to require the verifier to report on the extent and effectiveness of the applicant's consultation.	Cost and complexity – contributes towards a more efficient process by allowing assessment of applicant's consumer consultation earlier in the process.
Powerco response	Powerco supports the Commission's proposed amendments.	

4.2. Improvements to the way the DPP and CPP work together (Chapter 3)

100. The Commission is calibrating its approach to the DPP and CPP with the aim of accommodating suppliers' circumstances at a level of cost and scrutiny that is commensurate with the materiality of the price/quality changes experienced by consumers, within the legislative bounds of the price quality regime.⁴⁷
101. Powerco supports this approach. In practice there is a significant gap between a pure DPP on the one hand, and the significant commitment and cost of a comprehensive CPP on the other. Consumers are quite likely to find themselves served by EDBs that are constrained in suboptimal ways by a DPP but for whom the costs of a CPP do not stack up. The Commission can address this issue from both sides: by tailoring the DPP where sensible and scrutinising the cost and complexity of the CPP application process.
102. Powerco supports the addition of pragmatic, cost-effective mechanisms into the DPP process where they will better fit suppliers' circumstances, and ultimately promote the long-term benefit of consumers.⁴⁸
103. With respect to the CPP process, reducing the associated cost and complexity will make it more likely that EDBs will bring to the Commission CPP applications that are in the long-term interests of consumers. This will also improve the efficiency of the Commission's decision-making process.⁴⁹
104. While the Commission's approach to the interaction between the DPP and CPP take the framework in the right direction, we believe that there are some areas where further adjustments could be made to harness the full potential of the price quality regime. We discuss the Commission's proposals, our views, and our suggested amendments, below.

Tailoring / proportionate scrutiny principle

105. The Commission has signalled that it will look to tailor the DPP regime to cater for the circumstances of individual suppliers, providing this can be done without significantly increasing the cost of administering the DPP regime.⁵⁰
106. Powerco agrees with the Commission's view that it will sometimes be appropriate to treat some groups of suppliers differently under a DPP.⁵¹ This is consistent with the Commission's position as regards GPBs, where it is considering using suppliers' forecasts as a starting point for setting expenditure allowances.⁵² We endorse this approach.
107. That said, we reserve our position in relation to the Commission's view that "DPP IMs offer sufficient flexibility to allow [tailoring], and therefore no changes are needed".⁵³ Powerco considers it would be prudent to continue monitoring the implementation of the DPP IMs, and to make changes as necessary to ensure they are (and remain) as robust as possible.

⁴⁷ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [62].

⁴⁸ Powerco, "IM Review 2016: Submission on the four emerging view papers (29 February 2016)" (24 March 2016), at [24].

⁴⁹ Powerco, "Input methodologies review: Invitation to contribute to problem definition" (21 August 2015), at p 3.

⁵⁰ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [67].

⁵¹ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [69].

⁵² Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [70].

⁵³ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [71].

108. The Commission also proposes to adopt the proportionate scrutiny principle when resetting DPPs and assessing CPP applications, with the aim of reducing the associated cost and complexity:⁵⁴

This recognition of the costs and benefits of scrutiny, together with our experience of having now set a CPP and set and reset DPPs, informs the proportionate scrutiny principle. The configuration of the DPP, CPP, and the path change mechanisms within them, should generally aim to accommodate suppliers' circumstances at a level of cost and scrutiny that is commensurate with the materiality of the proposed changes to prices or quality experienced by consumers, within the constraints of the DPP/ CPP regime. Changes that would lead to material increases in prices or a material change in the quality of service should attract greater scrutiny.

109. In Powerco's view, this is a positive approach. As set out in previous submissions, we support the addition of pragmatic, cost-effective mechanisms into the DPP process to better meet suppliers' circumstances,⁵⁵ and consider the (inevitably significant) CPP process should be kept as simple as possible.⁵⁶ We agree with the Commission that both tailoring and proportionate scrutiny will ultimately deliver greater long-term benefits to consumers.
110. As regards the adoption of the proportionate scrutiny principles into the CPP process, the Commission's proposals include:
- 110.1 requiring CPP applicants to fulfil all base information requirements (i.e. information required for all expenditure categories), but leaving open the requirement to provide detailed information relating to the applicant's identified projects;
 - 110.2 applying the modification and exemption provisions on a case-by-case basis where this will not interfere with the Commission's assessment of a CPP proposal. This potentially includes reducing the information requirements for those suppliers already subject to a CPP;
 - 110.3 leaving open the process for suppliers transitioning from a CPP back to the DPP, as opposed to prescribing this in the IMs; and
 - 110.4 the Commission giving greater attention to the more material parts of a CPP proposal (such as scope/specificity of information requirements, verification and audit requirements, consumer consultation expectations, and satisfaction of the evaluation criteria).
111. Powerco supports the Commission's proposals. If necessary, we will provide comment on the Commission's implementation of the proportionate scrutiny principle in future when we have a better idea of how it translates into practice.

DPP / CPP reopeners

112. The Commission has proposed expanding the range of circumstances in which it would make DPP reopeners available.⁵⁷ In line with the Commission's emerging views on the

⁵⁴ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [62].

⁵⁵ Powerco, "IM Review 2016: Submission on the four emerging view papers (29 February 2016)" (24 March 2016), at [24].

⁵⁶ Powerco, "RE: Feedback on setting Orion's customized price-quality path" (14 April 2014), at [5].

⁵⁷ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [77].

matter,⁵⁸ Powerco agrees in principle with Commission's categorisation of the situations in which such DPP reopeners may apply.⁵⁹

113. We note the Commission has only sought to change the current IMs where this is likely to "significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose)".
114. Section 52A of the Commerce Act 1986 (the Act) sets out the purpose of Part 4 of the Act, being:
- ...to promote the long-term benefit of consumers... by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services –
- a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
 - b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
 - c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
 - d) are limited in their ability to extract excessive profits.
115. Expanding the list of circumstances in which both DPP and CPP reopeners are available to suppliers only (and not the Commission or third parties) is a practical method by which suppliers are empowered to tailor their own price-quality path. These reopeners, once applied for and determined by the Commission, are designed to give businesses certainty as they move through the relevant regulatory period. This increases the supplier's incentive to innovate, invest, and to provide efficiently priced, high quality services to consumers. This directly promotes the purpose of Part 4, as set out in s 52A.
116. We note the Commission has taken the following views in relation to the potential DPP and CPP reopeners listed below. We have provided our comments on each reopener the Commission has considered. Further comments on the proposed drafting of the IM determinations will be provided in our submission on 18 August 2016.
117. As regards DPP/CPP WACC alignment, we deal with this under Topic 4 below.

DPP reopeners

118. **Contingent/unforeseen projects for EDBs:** The Commission does not consider this to be an appropriate DPP reopener, as such projects are inherently linked with capex and, applying the proportionate scrutiny principle, would require in-depth analysis commensurate with the effect on consumers. In these circumstances a CPP is more appropriate.
119. Powerco supports the Commission's proposal at this stage, but we reserve our ability to provide more detailed comments in future when the effects of this amendment may be more apparent.

⁵⁸ Commerce Commission, "Emerging views on opportunities to improve the way default and customised price-quality paths work together" (29 February 2016), at [48].

⁵⁹ Powerco, "IM Review 2016: Submission on the four emerging view papers (29 February 2016)" (24 March 2016), at [32].

120. **Contingent/unforeseen projects for GTBs:** As above, the Commission considers such projects best suited to a CPP.
121. Powerco supports the Commission's proposal. We will provide further comments in due course if we have additional views on the effects of this proposal.
122. **Quality standards for EDBs:** The Commission considers a DPP quality standard reopener is appropriate, providing an EDB:
 - 122.1 can demonstrate the quality standards under the DPP are not realistically achievable; and
 - 122.2 submits a variation proposal that complies with the requirements set out in the IMs.
123. The Commission considers it appropriate to only allow this DPP to be reopened by application from a supplier. However, it also notes that the Commission is likely to be able to reopen this price-quality path under its proposed "expanded error" reopener discussed below.
124. This DPP reopener is designed to replace the quality-only CPP option.
125. Powerco supports the addition of this reopener, and considers the reopener is rightly reserved for suppliers only.
126. **Constant price revenue growth (CPRG):** The Commission does not recommend this DPP reopener, as it is likely to be redundant due to the proposal to change the form of control to a revenue cap.
127. Providing the Commission changes the form of control for EDBs to a pure revenue cap, Powerco agrees with the Commission that this reopener is now redundant. However, if the Commission retains WAPC, then we support the retention of this reopener.
128. Further, the Commission considers that there is no need to introduce a CPRG reopener for GDBs as they are not aware of any significant issues with GDB CPRG forecasting.
129. Powerco is also not aware of any significant issues with CPRG forecasting for GDBs. However, this does not mean that significant issues and errors will not arise in future. Where CPRG forecasts are found to be inappropriate early in a DPP period, this is likely to result in material under- or over-recovery of revenue over the duration of the regulatory period.
130. Powerco encourages the Commission to remove the risk of potentially significant over- and under-recovery by introducing a CPRG reopener for GDBs.
131. Powerco commends the Commission's engagement with stakeholders regarding CPRG forecasting as part of the gas DPP reset process. We support the continuation of this collaborative approach.
132. **Expanded error:** The Commission recommends extending the current scope of the error provision to address situations where a DPP was set on any type of error. This includes both the use of incorrect data, as well as using correct data that was wrongly applied.
133. Powerco supports this amendment, providing the Commission is clear that it will only reopen the DPP when data has truly been incorrectly applied, and not because an alternative methodology is in vogue.

134. **Workability:** The Commission recommends the use of a “next closest alternative” approach when IMs become unworkable. This would allow both the Commission and suppliers to reopen a DPP where necessary, to allow the supplier to implement the alternative approach.
135. Powerco agrees with this proposal in principle, but urges the Commission to take care in defining the scope of this reopener. We consider suppliers’ confidence in the regulatory regime will be undermined if the Commission has the ability to reopen price-quality paths at will.
136. Increasing suppliers’ certainty in the regulatory regime is a stated outcome of the Commission’s IMs review process. However, we are concerned that the current drafting of the workability reopeners in the marked up IMs gives the Commission the ability to make broad-spectrum changes to the DPP with few regulatory requirements to satisfy. As expressed by the ENA, we have concerns that this reopener circumvents the statutory process prescribed by the Commerce Act, and so may not be consistent with the Act’s framework.⁶⁰
137. In our view, we think the Commission should consider including additional thresholds or measures prior to being able to reopen price-quality paths on the basis of workability. At present, the leeway afforded by the drafting is likely to undermine suppliers’ confidence in the regime.
138. We agree with the ENA that the Commission should be required to consult on any proposed reopening prior to amending a price-quality path, and the scope of the workability reopener should be limited to compliance only (as opposed to the price path and quality standards more generally).⁶¹
139. **Major transactions:** The Commission recommends adopting this reopener for the DPP to cover situations where a major transaction makes the price-quality path unworkable. This DPP reopener would be available to both the Commission and suppliers.
140. Powerco supports the Commission’s proposal. If necessary, we will provide comments on this reopener in future when we have a clearer understanding of its effect.

CPP reopeners

141. **Contingent/unforeseen projects for EDBs and GTBs:** the Commission considers this reopener is appropriate given that a supplier’s expenditure would have already been scrutinised by the Commission. The Commission also proposes to amend this CPP reopener to include situations where major operating expenditure is required (as opposed to limiting this to capex).
142. Powerco supports the Commission’s proposal. If necessary, we will provide comments on this reopener in future when we have a clearer understanding of its effect.
143. **Expanded error:** the Commission has proposed extending the current scope of the error provision to address situations where a CPP was set on any type of error (including the use of incorrect data, as well as correct data wrongly applied).
144. Powerco supports this amendment, providing the Commission is clear that it will only reopen CPPs when data has truly been incorrectly applied, and not because an alternative methodology is in vogue.

⁶⁰ ENA, “Input Methodologies Review Draft Decisions: CPP requirements” (4 August 2016), at [11].

⁶¹ ENA, “Input Methodologies Review Draft Decisions: CPP requirements” (4 August 2016), at [12].

145. **Workability:** the Commission has proposed the use of a “next closest alternative” approach when IMs become unworkable. This would allow both the Commission and suppliers to reopen CPPs where necessary, to allow the supplier to implement the alternative approach.
146. As discussed above in relation to the DPP regime, Powerco agrees with this proposal in principle, but urges the Commission to take care in defining the scope of this CPP reopener. We consider suppliers’ confidence in the regulatory regime will be undermined if the Commission has the ability to reopen price-quality paths at will.
147. **Major transactions:** the Commission recommends adopting this reopener for CPPs to cover situations where a major transaction makes the price-quality path unworkable. This CPP reopener would be available to both the Commission and suppliers.
148. Powerco supports the Commission’s proposal. If necessary, we will provide comments on this reopener in future when we have a clearer understanding of its effect.

DPP reopeners vs single issue CPPs

149. Powerco supports the Commission’s efforts to further customise the generic DPP framework to cater to the needs of individual suppliers. As stated in previous submissions,⁶² we do not have a strong preference between DPP reopeners and single issue CPPs, providing it has the effect of reducing complexity and suitably tailoring the relevant price-quality path.

Approval of costs incurred prior to CPP approval

Summary

150. Powerco considers that costs should be able to be incurred prior to a CPP application being made to the Commission.
151. In our view, the Commission’s policy position must focus on the long-term interest of consumers. In this case, consumers are benefitted by prudent, timely investments being made, and recovering those investments. Indeed, it would be inconsistent with the Part 4 purpose statement to suggest that prudent investment should be delayed or not recovered, as neither is in the long-term interests of consumers.
152. We consider that giving suppliers the ability to recover costs prudently incurred prior to the application date would not alter the incentives on a supplier to submit a CPP application in a timely manner.

Prudent investment is in the consumers’ interest

153. The purpose of Part 4 is to promote the long-term benefit of consumers by ensuring, among other things, that suppliers have incentives to invest, including in replacement, upgraded, and new assets, to improve efficiency and provide services at a quality that reflects consumer demands.
154. As a starting proposition, and consistent with this purpose, suppliers should be able to recover their prudently incurred costs. It is the Commission’s role when considering a CPP application to determine whether costs are prudent, and if the Commission determines that investment is prudent, then it is consistent with the Part 4 purpose that those costs be

⁶² Powerco, “IM Review 2016: Submission on the four emerging view papers (29 February 2016)” (24 March 2016), at [32] – [35]; Powerco, “Input methodologies review: Invitation to contribute to problem definition” (21 August 2015), at [46].

recovered. Accordingly, there should be a sound justification for limiting or restricting suppliers' ability to recover their prudently incurred costs.

155. There should also be sound justification for influencing by regulation the timing of capital expenditure. The planning and implementation of capital projects should, as far as possible, be driven by considerations of network efficiency and consumer need, rather than by the regulatory process.

The Commission's draft decision

156. In its draft decision, the Commission accepts that additional net costs (over and above those provided for in a DPP determination), prudently incurred prior to the CPP period, should – at least to some extent – be recovered.
157. However the Commission proposes two limits on recovery of prudent investment. The Commission suggests that recovery should be limited to costs prudently incurred:
 - 157.1 in response to urgent projects, and
 - 157.2 only after a CPP application has been submitted but prior to the beginning of the CPP period.
158. The Commission reasons that to extend the recovery of prudent costs to those costs incurred prior to the CPP submission would remove the incentive for applicants to submit a CPP proposal in a timely manner.
159. The Commission also notes the desirability of minimising the level of controllable expenditure that is approved ex-post. The Commission's reasoning is not given, but appears to be driven by the practicalities of proving that costs were prudently incurred ex-post.
160. Powerco disagrees with this approach. In Powerco's view, the starting point must be that the long-term interest of consumers is in prudent investments being made, being made at a time that is consistent with network and consumer demands, and is recovered. The Part 4 purpose statement sets a high bar for any suggestion that prudent investment be delayed or not recovered, as neither is in the long-term interests of consumers.
161. Concerns regarding incentives and practicalities do not provide a sufficient justification for the proposed restriction on suppliers' ability to recover CPP-consistent costs, prudently incurred prior to CPP approval. Indeed, the mechanism proposed by the Commission gives it discretion to determine whether the expenses incurred were prudent and consistent with the CPP for which the applicant is seeking approval.

Incentives to submit a CPP proposal in a timely manner

162. In Powerco's view, an ability to recover costs prudently incurred prior to the application date would not alter the incentives on a supplier to submit a CPP application in a timely manner.
163. A supplier knows it is still required to submit a CPP application and have it approved, before the supplier is able to recover prudently incurred pre-CPP expenditure. It is exposed to the possibility of the Commission disagreeing on the question of prudence, and for that reason not recovering. This in itself is an incentive to submit an application in a timely manner.

164. A supplier does not aim to be in the position of incurring costs before receiving regulatory approval of its ability to recover those costs. It is important to be clear about the motivations of an EDB in such a situation. If it were a purely financial decision, the business would wait for regulatory approval before incurring costs. It would simply delay the prudent investment to a later, sub-optimal time. However, there are other factors at play, including safety and reliability, customer expectations, and the long-term efficient management of the network. The EDB will be responding to those considerations and taking on the risk of making capital expenditure ahead of an acknowledgement by the Commission that the investment is CPP consistent and prudent.
165. There is also the practical issue of synchronising efficient asset planning, with the preparation and submission of a CPP application.
166. Good planning can take a supplier only so far. As the Commission is aware, preparing a CPP application is a multi-year undertaking which may be substantially influenced by factors other than asset management considerations. In Powerco's experience, for example, timing of its CPP application has been driven in large part by the need to resolve the WACC alignment issue. The CPP application process also requires a supplier to commission multiple independent expert reports, undertake consultations with consumers, and devote significant internal resource to preparing a robust proposal. For all of these reasons, suppliers cannot predict with precision how long the CPP application process will take.
167. From the perspective of efficient asset planning, investment requirements are driven by entirely different factors: network performance, changes in consumer demand, funding, and so on.
168. Accordingly, it is difficult, if not impossible, for a supplier to synchronise the timing of a CPP application with the efficient planning and implementation of capital projects.
169. If efficient asset planning dictates that a project should commence prior to the submission of the CPP application, then the IMs should encourage suppliers to undertake that work at the time that best advances the long-term interests of consumers, rather than defer it until the date of the application.

Practicalities of assessing prudence ex-post

170. Powerco acknowledges the potential practical difficulty in assessing ex-post whether pre-CPP costs were prudently incurred and consistent with the CPP application. Generally speaking, it will be more difficult to assess the prudence of expenditure, and its connection with the CPP proposal, the farther back one goes. However, these concerns could be overstated for recent expenditure.
171. The competing consideration is that to ensure that capital expenditure is driven by network efficiency considerations rather by the regulatory timetable - as the long-term interests of consumers require - suppliers need an appropriate window to make CPP-consistent spend, prior to receiving CPP approval.
172. In Powerco's estimation, the 12 months prior to a CPP application are likely to be the most critical. During this period, the supplier will have identified the need to apply for a CPP, and most likely signalled this to the Commission. It will be developing its asset management plan, and will be well-advanced in preparing its CPP application. The connection between any capital expenditure and the CPP will be clear. But the supplier is also likely to be under pressure to start investing in the projects which form the basis of its CPP application.

173. In Powerco's view, if the supplier can demonstrate that pre-CPP costs were prudently incurred and consistent with its CPP asset management plan, then those costs should be able to be recovered.
174. If there is to be a bright line cut-off date, then it should at a minimum be extended to include prudent CPP-consistent spend in the 12 months prior to the CPP application. Ideally, suppliers would have the opportunity to recover prudent, CPP-consistent spend in the 24 months prior to the CPP application.

“Urgency” an inappropriate restriction on pre-CPP cost recovery

175. The draft decision indicates that recovery of pre-CPP costs would be limited to costs associated with “urgent projects”. This language suggests that pre-CPP cost recovery would only be available for emergency or unforeseen expenditure. The Commission's reasoning is not explicit, but appears again to be driven by the concern at creating an incentive to delay an application, and/or the practicalities of proving that costs were prudently incurred ex-post. Both of these concerns are addressed above.
176. There is no doubt that the urgency criterion would materially reduce the pool of potentially recoverable prudent costs. But there is no obvious reason, at least none connected to the purpose of Part 4, to limit the recovery of prudently incurred costs in this way. Practically, it would mean that the ex-post recovery mechanism was of limited utility to suppliers seeking to coordinate asset management planning with the CPP application process. It is also inconsistent with the principle that regulation should encourage prudent investments to be made at the time that best advances the long-term interests of consumers.
177. In Powerco's view, the urgency criterion is an inappropriate and unnecessary restriction on a supplier's ability to recover prudent pre-CPP costs and should be removed.

Powerco's proposal

178. Powerco's proposal is that the new recoverable cost allowance provide for the recovery of prudently incurred CPP-consistent costs where:
- 178.1 the costs are incurred:
- (a) in the 24 months prior to the submission of a CPP application; or
 - (b) between submission of the CPP application and the determination of a CPP;
- 178.2 the CPP is accepted for consideration by the Commission; and
- 178.3 the Commission approves the cost by specifying it in the CPP determination.
179. Powerco agrees that the Commission should retain the discretion to decline the recovery of pre-determination costs that were not considered to be consistent with the “investment case” submitted and approved as part of a CPP application (ie, non-CPP-consistent costs).
180. In addition, the current IRIS framework means that a supplier would face a financial penalty for pre-CPP capex that exceed the DPP capex allowances, on the basis that the excess represents an “inefficiency”, even though the Commission might subsequently determine that the additional capex was prudently incurred and recoverable under the CPP. In Powerco's view, the DPP IRIS should not incentivise CPP applicants to defer capital works that would otherwise, in the interests of consumers, commence earlier. Similarly, the DPP IRIS should not financially penalise suppliers for efficient asset planning.

Implementation

181. Powerco's proposal involves two elements:
- 181.1 first, an amendment to the IMs to provide for the full recovery of costs associated with a CPP application during the two years preceding the commencement of the CPP; and
 - 181.2 second, an amendment to the IRIS mechanism to ensure suppliers are not penalised for prudently incurred pre-CPP costs.
182. These proposals could be implemented with straightforward amendments to the IMs. The existing mechanism for recovery of costs associated with responding to a catastrophic event provides an analogy for Powerco's proposal and demonstrates that Powerco's proposal can be readily implemented.⁶³

Expanding the range of pass-through costs

183. The Commission proposes to allow criteria-based pass-through costs to be specified in a DPP or CPP determination, as opposed to being specified by amendment to an existing determination. It also proposes amending the IMs to allow any type of cost that meets the pass-through cost criteria to potentially be specified as a pass-through cost in a DPP determination (as opposed to just levies).⁶⁴
184. Separately, the Commission does not consider it appropriate to allow additional costs associated with preparing a CPP application to be included within the definition of recoverable costs.⁶⁵ In the Commission's view, it is appropriate for the applicant to bear some of the costs of preparing an application in order to incentivise cost minimisation.
185. For suppliers subject to the DPP, following the introduction of the IRIS, temporary costs not directly recoverable from consumers will be shared between suppliers and consumers. This reflects an increase in the costs borne by suppliers, which currently cover 34% of the associated costs.
186. We agree with the ENA's submission that expanding the range of pass-through costs will improve the workability of the original IMs.⁶⁶ Powerco also queries whether GIC fees could also form part of these additional costs.

4.3. Evaluation of CPP proposals (Chapter 4)

187. We appreciate the Commission taking this opportunity to explain and clarify its approach to evaluating CPPs. In particular, we note the Commission's aim to make the CPP application process as cost-effective and straightforward as possible, while also employing the proportionate scrutiny principle. This should enhance the CPP application process, ensuring CPPs are determined in a timely manner.⁶⁷

⁶³ Prudently incurred pre-CPP costs should be recoverable in full. Powerco's proposal is that pre-CPP capex would be assessed applying the same standards that the Commission applies to capex included in a CPP application under the current rules. The only difference would be that pre-CPP capex is recovered ex-post.

⁶⁴ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [121].

⁶⁵ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [124] – [125].

⁶⁶ ENA, "Input Methodologies Review Draft Decisions: CPP requirements" (4 August 2016), at [40].

⁶⁷ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [155].

188. We agree the CPP application process should be kept as low cost and as simple as possible. That said, we recognise that it is inevitably a significant task which will always cost suppliers (and the Commission) a good deal in both time and resources.⁶⁸
189. Powerco has made a number of observations in relation to Orion’s CPP experience. These are contained in our submission to the Commission dated 14 April 2014. We encourage the Commission to review this submission.
190. The various moving parts and complexity of the CPP process are encapsulated by Attachment A (the indicative CPP application process diagram).
191. Some of the Commissions’ key themes in its approach to CPP applications are set out below:
- 191.1 Adopting a building blocks approach for determining CPPs (consisting of price path information, proposed expenditure information, and quality variation information);
 - 191.2 The Commission’s focus on the right expenditure, at the right time, at the right cost;
 - 191.3 “Top down” assessment of expenditure, with a limited “bottom up” review of selected projects/programmes. There will be an emphasis on working down from suppliers’ policies, strategies and processes;
 - 191.4 Implementation of the proportionate scrutiny principle, meaning a greater focus on the material elements of the proposal (i.e. those with the greatest potential impact on price/quality);
 - 191.5 Suppliers must product a “fit for purpose” CPP proposal (with prescriptive base information requirements, and some flexibility around the more detailed information);
 - 191.6 The Commission will factor in a supplier’s size when assessing its degree of scrutiny.
192. Powerco considers the Commission’s approach should focus on providing flexibility in the format and level of information an applicant is required to supply as part of the CPP application process. Further, the application process should be sufficiently robust to ensure the Commission has all relevant information at its disposal, but also allowing applicants sufficient time to do all they need to do in order to adequately prepare for the process.
193. As the Commission’s approach to assessing CPP applications is not set out in the IMs governing CPP proposals, we have focused on how the process might be affected by the Commission’s proposed changes to the IMs. This is discussed below.

4.4. Information requirements (Chapter 5)

194. The Commission has proposed certain changes to the CPP information requirements, which it intends will reduce the cost and complexity of the CPP process. In doing so, the Commission has sought to employ the proportionate scrutiny principle throughout the process, therefore focusing on those elements likely to have the greatest impact on price and quality.⁶⁹

⁶⁸ Powerco, “RE: Feedback on setting Orion’s customized price-quality path” (14 April 2014), at [5].

⁶⁹ Commerce Commission, “Input methodologies review draft decisions – Topic paper 2: CPP requirements” (16 June 2016), at [238] – [239].

195. The changes are to Schedules D and E.⁷⁰ To reduce the cost and complexity of preparing a CPP application the Commission proposes:
- 195.1 removing the need to duplicate information between documents, by aligning Schedules D and E with the relevant information disclosure requirements;
 - 195.2 removing superfluous information;
 - 195.3 aligning the expenditure tables in Schedule E with the ID requirements, where appropriate;
 - 195.4 removing the requirements for forecasting capex projects disaggregated by asset type; and
 - 195.5 changing the requirements for related party transactions to an aggregate level of capex, rather than a project level.
196. To ensure it has the necessary information to evaluate a CPP application, the Commission proposes:
- 196.1 new requirements for a deliverability plan for the proposed expenditure; and
 - 196.2 requiring both real and nominal prices to be included in the forecast tables.
197. As discussed above, in principle we agree that the CPP regime will be improved by streamlining the application process. We also see benefit in removing those information requirements that are no longer aligned with other aspects of the CPP framework.⁷¹
198. We also note the importance of the modification and exemption mechanism, which gives CPP applicants the opportunity to tailor their information requirements at the outset of the CPP process. While this mechanism has not yet been used, Powerco considers this will bring the proportionate scrutiny principle to life in the CPP application process. The information requirements, therefore, should be considered with this mechanism in mind.
199. The Commission's proposed changes to the CPP information requirements are discussed below. We propose to provide substantive comments on the amendments to the determinations in our submission due 18 August 2016.
200. **Duplication:** the Commission recommends removing the need to duplicate information between documents, by aligning Schedules D and E with the relevant information disclosure requirements. The Commission intends to adopt an "AMP-plus" approach", recognising the AMP contains some (but not all) of the information needed in Schedule D.
201. Powerco supports the Commission's proposal to align Schedules D and E with the ID requirements. However, we may provide further comment in future once we have a better understanding of how the proposal works in practice.
202. **Deliverability plan:** the Commission proposes to include new requirements for a deliverability plan for the proposed expenditure.

⁷⁰ Commerce Commission, "Input methodologies review draft decisions – Topic paper 2: CPP requirements" (16 June 2016), at [225].

⁷¹ Powerco, "Input methodologies review: Invitation to contribute to problem definition" (21 August 2015) at [74.4] – [74.5].

203. Powerco supports the view that the Commission should consider the deliverability of the proposed expenditure. However, we question the need for a specific requirement that an applicant must produce a separate plan at the outset. It may become clear as the CPP process progresses that the applicant requires modifications and exemptions, which may feed into a deliverability plan being created at a later stage in the process.
204. **Capex projects:** the Commission proposes to simplify the requirement for forecasting capex projects disaggregated by asset type.
205. Powerco supports the Commission's proposal, and will provide comments in future if its views change. Any comments on the substantive changes to the IMs will be provided in our submission on 18 August 2016.
206. **Related party transactions:** the Commission recommends changing the requirements for related party transactions to an aggregate level of capex, rather than a project level.
207. Powerco considers the Commission's proposed amendments reflect the information requirements in the ID. This should reduce the costs and complexity faced by suppliers when preparing CPP applications. We will provide comments on this proposal in future should our views change.
208. **Expenditure:** the Commission proposes to remove the requirement for expenditure to be disaggregated by service categories.
209. Powerco supports the Commission's proposal. Should our views change, we will inform the Commission in due course.
210. **Demonstrating deliverability:** the Commission recommends improving the way in which applicants demonstrate the deliverability of their proposed expenditure.
211. Powerco supports the Commission's proposal, and will provide comments in future if its views change. Any comments on the substantive changes to the IMs will be provided in our submission on 18 August 2016.

General comments

212. Powerco agrees with the measures the Commission has proposed to simplify and reduce the volumes of information sought throughout the CPP process. During Orion's CPP process, we observed that a good deal of information was prepared for the Commission that was surplus to requirements, and so we are pleased to see the Commission has turned its mind to more practical and less onerous methods of gathering the necessary information.
213. As noted above, we think the modification and exemption mechanism will also play an important role in ensuring the CPP application regime is sufficiently flexible to cater to each supplier's individual circumstances.
214. We note that it may take some trial and error before the Commission (and suppliers) are fully satisfied with the CPP information requirements. As such, we ask that the Commission keep these information requirements in review as it receives further CPP applications.

4.5. Verification requirements (Chapter 6)

215. The Commission has proposed changes to the verification requirements to clarify the verifier's role, and to simplify the verifier's engagement with the Commission and the

supplier. These changes are designed to give suppliers greater certainty, as well as reducing the cost and complexity of CPP applications.

216. In principle, Powerco agrees with the direction in which the Commission is heading with these proposed changes. We see reduced cost and complexity, as well as increased supplier certainty, as appropriate outcomes of this review.
217. The Commission's proposed changes to the verification requirements include the following matters. We propose to provide substantive comments on the amendments to the determinations in our submission due 18 August 2016.
218. **Role definition:** the Commission proposes adding a new section to the verifier's Terms of Reference in Schedule G of the IMs that defines the verifier's role, purpose, and obligations.
219. Powerco supports the Commission's efforts to clarify the role of the verifier in further detail. Additional comments on the substantive amendments to the determinations will be provided in our submission due 18 August 2016.
220. **Application summary:** the Commission recommends requiring the CPP applicant to supply the Commission with a high level summary of their application by the time the verifier is engaged.
221. Powerco does not support this proposal. As set out in the ENA's submission,⁷² we consider this report is not justified, as it will add undue cost and complexity to the CPP process. That said, we consider that the Commission could glean the information it requires at this stage of the CPP process via a meeting with the applicant and verifier. This would have the benefit of being low-key, low cost, and does not require the applicant to spend additional time and resources preparing further documentation.
222. **Communication protocol:** the Commission recommends amending the tripartite deed requirements in Schedule F5 to include a communication protocol that sets out the roles and obligations of the parties during the verification process regarding communication, and to allow meeting minutes to be used as the evidential basis for any verifier technical opinions.
223. Powerco supports the Commission's proposal. Should our views change, we will inform the Commission in due course.
224. **Greater verifier flexibility:** the Commission proposes allowing the verifier greater flexibility in the number of projects that are verified, the extent of their verification, and the content of the CPP proposal that the Commission reviews.
225. Powerco agrees in principle that giving verifiers greater flexibility is a good thing; however, we consider that the verifier should be required to verify a maximum of 10 projects, as opposed to the suggested 20. In our view, providing scope for a verifier to review 20 projects is excessive, while reviewing 10 projects would be adequate for the purposes of the verifier's review. This is consistent with the application of the proportionate scrutiny principle.
226. In any case, all of an applicant's projects will be subject to review as part of the CPP application process. Limiting the verifier's scope to a maximum of 10 projects does not curtail the Commission from looking into any project as part of its review as it sees fit.

⁷² ENA, "Input Methodologies Review Draft Decisions: CPP requirements" (4 August 2016), at [94] – [96].

227. Further, the requirement that verifiers must assess the reasonableness of historical decisions relating to quality is inappropriate, and goes beyond the scope of what is necessary for the purposes of the CPP application. We do not believe this requirement is necessary.
228. In line with the ENA's submission, we also recommend that the associated draft guidance is improved.⁷³
229. **Removal of non-standard depreciation consideration:** the Commission proposes removing the obligation for the verifier to consider non-standard depreciation.
230. Powerco supports the Commission's proposal. Should our views change, we will provide comments to the Commission as necessary.
231. **Removal of engineer verification:** the Commission recommends removing the requirement for an independent engineer, and allowing suppliers to prepare the quality standard variation report themselves, subject to verification by the verifier (EDBs only).
232. Powerco supports the Commission's proposal. Should our views change, we will provide comments to the Commission as necessary.

4.6. Audit requirements (Chapter 7)

233. The Commission is intending to change the audit requirements associated with a CPP application in order to provide greater certainty for CPP applicants as to the Commission's audit expectations. As we have previously submitted, the audit requirements as they currently stand appear very arduous, and in need of streamlining and improvement.⁷⁴ The aim of these proposals, therefore, is something Powerco supports.
234. We discuss each of the proposed changes below. Substantive comments on the amendments made to the determinations will be provided in our submission due 18 August 2016.
235. **Auditor opinion:** the Commission proposes clarifying the requirement for the auditor to provide a report setting out the auditor's opinion on specified matters.
236. Powerco supports the Commission's proposal. If our views change, we will update the Commission in due course.
237. **Historical financial information:** the Commission proposes differentiating the role of the auditor with respect to historical financial information and forecast financial information.
238. Powerco supports the Commission's proposal. If our views change, we will update the Commission in due course.
239. **Quantitative spreadsheet information:** the Commission recommends removing ambiguity around quantitative information provided in spreadsheets.
240. Powerco supports the Commission's proposal. If our views change, we will update the Commission in due course.
241. **Proper records:** the Commission proposes clarifying the requirement on the auditor to provide a view in respect of proper records being kept.

⁷³ ENA, "Input Methodologies Review Draft Decisions: CPP requirements" (4 August 2016), at [98].

⁷⁴ Powerco, "RE: Feedback on setting Orion's customized price-quality path" (14 April 2014), at [22].

242. Powerco supports the Commission's proposal. If our views change, we will update the Commission in due course.

4.7. Consumer consultation requirements (Chapter 8)

243. The Commission has proposed two changes to the IMs to provide greater certainty about its expectations for consumer consultation.

244. As we have previously noted,⁷⁵ the current IMs do not currently provide enough guidance on the level of consultation required by the Commission. Specifically, Powerco would like the Commission to clarify what it considers to be needed (or good practice) for a CPP application.

245. We discuss our views on the Commission's proposals below.

246. **Alternative investment options:** the Commission recommends amending the consumer consultation IMs to require CPP applicants to notify consumers of the price and quality impact of any alternative investment options in its CPP proposal.

247. Powerco supports the Commission's efforts to strike the right balance between prescription (ensuring the Commission is clear on its consultation expectations) and flexibility (ensuring suppliers have leeway to undertake consultation in a way that suits them).

248. However, we agree with the ENA that consumer consultation should not include consultation on price/quality trade-offs for all alternative investment options. Rather it should focus on alternative investment options which relate to the key reasons for the CPP proposal.⁷⁶

249. **Verification of consultation:** the Commission proposes amending the verifier Terms of Reference in Schedule G of the IMs to require the verifier to report on the extent and effectiveness of the applicant's consultation.

250. Powerco supports the Commission's proposed change. If our views change, we will update the Commission in due course.

⁷⁵ Powerco, "RE: Feedback on setting Orion's customized price-quality path" (14 April 2014), at [9] – [15].

⁷⁶ ENA, "Input Methodologies Review Draft Decisions: CPP requirements" (4 August 2016), at [103].

5. Topic 3: The future impact of emerging technologies in the energy sector

5.1. Summary

251. Powerco supports the Commission's approach to emerging technologies in the energy sector. In particular, we appreciate the fact that the Commission has not made any "knee-jerk" reactions to the prospect of new technologies without a proper evidential basis for doing so. This would be inconsistent with the Commission's stated framework.
252. The proposed mechanism to allow the reduction of asset lives by 15% appears to be a tidy, low-risk method through which suppliers can manage the risk of asset stranding. We support the inclusion of this mechanism in the IMs.
253. We do, however, suggest the Commission reconsider its proposal to reduce the 20% ACAM threshold to 10%. In our view, the rationale behind this proposal is not clear, and may be based on some incorrect assumptions.
254. In any case, given the fluid and unpredictable advances in emerging technologies, it may be appropriate for the Commission to offer a mid-period review of this topic.

5.2. The changing energy landscape

255. Powerco agrees with the Commission's description of the potential challenges presented by emerging technologies in the energy sector. The forces of emerging technologies (that are lowering costs, improving performance, and increasing capabilities), new business models, and changes in consumer behaviour have the potential to simultaneously reduce demand for regulated lines services (by creating substitutes) and increase demand (by creating new and complimentary services).⁷⁷
256. Further uncertainties are the pace of any change, and the ways in which these changes may blur the boundaries between the participants in different vertical segments of electricity market.
257. In these circumstances, the Commission is taking the right stance:
- 257.1 focusing on its purpose of promoting the long-term interests of consumers of regulated services,⁷⁸
 - 257.2 maintaining or enhancing the flexibility that the IMs give businesses to respond and adapt.⁷⁹ The IMs should not discourage suppliers (or others) from using new technology and new business models for their and consumers' benefit,⁸⁰
 - 257.3 investing in understanding potential emerging technology-related developments,⁸¹ and

⁷⁷ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [27].

⁷⁸ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [30].

⁷⁹ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [31].

⁸⁰ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [X7].

257.4 encouraging open debate and dissemination of knowledge in the sector.⁸²

258. The Commission proposes incremental changes in two areas (discussed below):

258.1 Anticipating the potential effect of emerging technologies on demand, and its potential to result in price shocks to consumers and the chilling of investment where investors perceive the risk of economic stranding;

258.2 Ensuring suppliers have incentives to take advantage of economies of scope presented by new technologies and business models, and to share those efficiencies with consumers.

259. This is consistent with the approach suggested by Powerco during the Commission's consultation on its emerging views. Emerging technologies have the potential to have a dramatic impact on the sector in the future, and it may be that when those impacts are known the IMs will require amendment. However the nature of the impacts and their timing is currently quite unclear. It would be inappropriate to make substantial amendments to the IMs in this review cycle. Rather, the emphasis should be on understanding the issues and monitoring developments.

5.3. Risk of partial capital recovery

260. Under the current framework EDBs are not exposed to asset / physical stranding, as the value of capital investments stay in the RAB. However EDBs are exposed to the risk that the investment in the RAB cannot be recovered from consumers as a whole – economic stranding. One way this can happen is if the prices set to recover the RAB investment exceed consumer willingness to pay.

261. The Commission rightly recognises that emerging technologies increase the risk of economic stranding for EDBs. Technology may empower consumers to generate and store electricity, and competitors may offer services that bypass use of the network. If this becomes widespread, then in one potential future scenario EDBs will need to recover their prudent investments from a reduced number of consumers. Prices in this scenario will need to increase. At some point, ever-increasing prices will not be feasible and the investment will be stranded.

262. The Commission rightly recognises this scenario is not the only possible outcome of the widespread penetration of emerging technologies. The new technologies will act on demand and use of the network in opposing ways. Whether likely stranding has become more likely is difficult to assess. But the uncertainty associated with this scenario has increased.

263. The probability of this scenario being greater than zero means that EDBs cannot completely expect to recover their return of and return on capital. This breaches the Commission's FCM principle, which underpins much of the Part 4 framework.⁸³

264. To reduce the probability of this scenario the Commission proposes to allow EDBs to apply to reduce asset lives by up to 15%. This would have the following features:

⁸¹ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [44.1].

⁸² Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [44.2]

⁸³ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [76].

- 264.1 The application would be made by suppliers at the time of the DPP reset.⁸⁴ (We note, however, that it is unclear how this would fit into the DPP reset process in practical terms).
- 264.2 The Commission proposes to make this asset life adjustment mechanism available to suppliers regulated by the DPP as well as individual CPPs.
- 264.3 It will have the effect of accelerating cash flows, and in this way reducing the risk of economic stranding.
- 264.4 It would be net present value (**NPV**) neutral. There would be no windfall gain or loss to the EDB. The change would be to the time profile of investment recovery.
- 264.5 The Commission would consider the application to determine the impact on price increases to consumers, to ensure these are not excessive.⁸⁵ In practice, this is likely to incentivise EDBs to bring applications to the Commission at an appropriate time, when it is feasible for the price profile to be smoothed.
265. Powerco supports this approach. This is an elegant solution tailored to the current context. It recognises the increased uncertainty faced by EDBs, it puts a solution in the hands of EDBs, it is NPV neutral, and it makes clear the Commission's role to check against price shocks for consumers.
266. However, the scope of how this adjustment factor would work in practice is currently unclear. It would be helpful if the Commission could further consider and provide guidance on how this proposal would work from a practical perspective.

5.4. Regulatory treatment of revenues and costs from emerging technology

267. The emerging technologies increase the likelihood of EDBs selling unregulated services and earning unregulated revenue. In response, the Commission has examined the cost allocation IM to ensure it is working appropriately.
268. The Commission proposes to lower the unregulated revenue materiality threshold at which a supplier must move from ACAM to ABAA or OVABAA from unregulated revenues at 20% of total revenue to 10% of total revenue. The purpose of doing so is to improve the sharing of scope and diversification efficiency gains with consumers (ABAA is likely to require a greater degree of sharing than ACAM). The Commission believes this change will not reduce the incentives on EDBs to diversify.⁸⁶
269. In Powerco's opinion, the rationale behind the reduction of the 20% ACAM threshold to 10% is not clearly explained by the Commission, and is based on some assumptions that may not stand up to close scrutiny. These assumptions are set out in the ENA's submission,⁸⁷ and so we do not restate them here. We agree with the ENA's conclusion that, without credible evidence to the contrary, the current 20% threshold should be maintained.⁸⁸
270. We also ask that the Commission clarify its approach in relation to the following matters:

⁸⁴ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [85].

⁸⁵ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [92].

⁸⁶ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [144].

⁸⁷ ENA, "Submission on Draft IM Decision Impact of emerging technologies" (4 August 2016), at [27].

⁸⁸ ENA, "Submission on Draft IM Decision Impact of emerging technologies" (4 August 2016), at [28].

270.1 Customer contributions: Powerco is unclear as to whether these contributions form part of the regulated or unregulated asset base; and

270.2 Regulated revenue: the Commission is not consistent in whether this includes both regulated electricity revenue and gas revenue, or whether this is limited only to electricity. In Powerco's view, total regulated revenue should include revenue from both gas and electricity regulated businesses.

271. The Commission also proposes to require more rigour when selecting and applying allocators. In particular, before applying a proxy allocator when applying the ABAA, the EDB must demonstrate that:⁸⁹

271.1 a causal relationship cannot be established; and

271.2 the proxy cost allocator proposed is appropriate.

272. The Commission proposes to:

272.1 increase information disclosure requirements;

272.2 require a declaration from the CFO that no causal relationship can be established and the proxy cost allocator proposed is appropriate; and

272.3 make this a focus of compliance in the future.

273. Powerco supports the Commission's proposals, but does not understand the rationale behind the requirement that the CFO must declare that no causal relationship can be established and that the proxy cost allocator is appropriate. As noted by the ENA,⁹⁰ the disclosed rationale will be certified by directors as part of the overall certification of the disclosures and this should provide comfort to interested parties regarding the accuracy of disclosures. We consider this requirement is unnecessary.

5.5. Issues raised by electricity retailers

274. The Commission records that it received a number of submissions from electricity retailers on wider issues that do not fit well in this IMs review. Powerco has submitted its views to the Commission previously.⁹¹ Powerco agrees with the Commission that an IMs review is not the process in which to debate issues of:

274.1 industry structure;

274.2 the boundary between competition and regulation; and

274.3 regulatory settings selecting or preventing a particular business model to invest in emerging technologies.

275. Powerco continues to believe the competition concerns expressed by electricity retailers are overstated. EDBs may have scope efficiencies in investing in emerging technologies, but if so that is an efficiency worth capturing and sharing with consumers of both regulated and unregulated services. This may be a source of competitive advantage for EDBs. Other competitors will have other sources of competitive advantage, including electricity

⁸⁹ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [129].

⁹⁰ ENA, "Submission on IM Draft Decision Impact of emerging technologies" (4 August 2016), at [30].

⁹¹ Powerco, "Input Methodologies Review: Regulatory Treatment of Emerging Technologies" (4 February 2016).

retailers (relationships with consumers) and technology companies (access to capital and IP). There is no case for policy makers or regulators to pick winners at this stage, nor to constrain how EDBs might evolve in response to changes in technology and consumer demand.

276. Powerco agrees with the Commission that the current definition of the regulated service does not constrain the technology that an EDB can use or the way the EDB chooses to provide the regulated service. As we stated in our 4 February 2016 submission, we agree with the Commission that:⁹²

276.1 whether an asset is used for the conveyance of electricity by line, or the costs are attributable to the conveyance of electricity by line, is an appropriate test for whether that asset should be included in the RAB; and

276.2 accordingly, assets beyond the point of supply, or otherwise not physically part of the network, should be included in the RAB to the extent that they are used for the conveyance of electricity by line, or their costs are attributable to the conveyance of electricity by line.

277. Where we depart from the Commission is that we do not agree that the definition of lines is relevant only insofar as it demonstrates an intention to define the regulated service in a way that is understood to include transmission and distribution network services. In our view, if an asset demonstrably falls within the legislative definition of the regulated service, that is sufficient reason to include it in the RAB without having to make a further inquiry.

278. Put another way, we think the test for inclusion of an asset in the RAB has two limbs:

278.1 if an asset is physically used in the conveyance of electricity by line (i.e. it conveys electricity and is part of the distribution network as defined in the Electricity Act 1992), then it is part of the regulated service as defined in section 54C of the Commerce Act, and should be treated as such;

278.2 alternatively, if an asset is not physically part of the distribution network but is nonetheless used to deliver the regulated service (in the Commission's sense that it supports the regulated service or its costs are attributable to it), and then it would be appropriate to include that asset in the RAB subject to the cost allocation IM.

279. This two-limbed approach is the natural consequence of the relationship between the IMs and the legislative definition of the regulated service in the Commerce Act and Electricity Act.

280. We do not consider that any material changes to the IMs are required to give effect to, or clarify, this position.

281. It follows that we agree with the Commission when it states:⁹³

...it is important to note that the focus of the definition of the regulated service is on the service provided, not on specific types of assets. Although assets are relevant insofar as they are used to support the service, where an asset is used in a way that does not support the regulated service – that is, used to provide a non-regulated service – it is the use of the asset that is excluded from the service, not the asset itself.

⁹² Powerco, "Input Methodologies Review: Regulatory Treatment of Emerging Technologies" (4 February 2016), at [19] – [23].

⁹³ Commerce Commission, "Topic paper 3: The future impact of emerging technologies in the energy sector" (16 June 2016), at [194] – [197].

...

In this respect, it is important to note that, while suppliers have some discretion on the assets they use to support the regulated service, the onus of proof is on them to justify that the costs and revenues attributed to those assets relate to the delivery of the regulated service and have been allocated in the appropriate proportions.

Second, in our view there is no requirement that all assets used to support the conveyance of electricity by line must themselves be 'lines'. The definition of 'line' in the Electricity Act is incorporated into 'electricity lines services' "unless the context otherwise requires." Thus, 'line' must be interpreted in the context of the purpose of Part 4 when used in relation to the definition of the regulated service. In our view, it is unlikely that this term, which excludes certain classes of assets, is intended to operate to restrict the scope of the regulated service under Part 4.

282. Likewise, in line with the ENA's submission,⁹⁴ we do not support the Electricity Retailers' Association of New Zealand's (**ERANZ**) proposal to ring-fence EDB investments in emerging technologies. We agree with the Commission that the current definition of the regulated service does not constrain the technology that an EDB can use or the way an EDB chooses to provide the regulated service.
283. As set out in Powerco's previous submission on the Commission's regulatory treatment of emerging technologies, we think the Commission should monitor the relevant markets and activities as they evolve, rather than pre-empt the development of emerging markets now.⁹⁵ To that end, it may be appropriate for the Commission to offer a mid-period IM review on this topic.

⁹⁴ ENA, "Submission on Draft IM Decision Impact of emerging technologies" (4 August 2016), at [8] – [9].

⁹⁵ Powerco, "Input Methodologies Review: Regulatory Treatment of Emerging Technologies" (4 February 2016), at p 6.

6. Topic 4: Cost of capital issues

6.1. Summary

284. We have limited our comments to the Commission's proposals to:

284.1 reduce the allowance for debt issuance costs;

284.2 remove the adjustment to asset beta for GPBs;

284.3 reduce the notional leverage to 41%; and

284.4 align the DPP and CPP WACCs.

285. Enclosed with this submission is a report from HoustonKemp, prepared on behalf of Powerco, which addresses in detail:

285.1 estimating debt issuance costs;

285.2 asset beta; and

285.3 implications of the form of control for cost of capital.

6.2. Cost of debt

286. Powerco does not agree with the Commission's proposed reductions to the allowance for debt issuance costs. In our view the information the Commission has used to assess current market levels of issuance costs has been poorly sourced and too great a reliance has been placed on a small sample of incomplete data.

287. Powerco provides evidence in the form of its own data, and from disinterested sources that shows the costs to issue debt under the Commission's preferred 'simple' approach are greater than the proposed allowance.

288. Additionally, Powerco queries whether the incomplete data the Commission has based its draft decision on is sufficient in scope and breadth to give confidence that the confidential survey can be adequately relied upon by the Commission to reflect accurate costs. Powerco provides the Commission with a recommendation to poll more widely, and to seek the view of industry experts, on the matter.

289. Powerco has previously proposed consideration of additional costs that are unavoidably incurred by an efficient debt issuer, and that are not currently recognised in the IMs.⁹⁶ The omission of these costs has not been addressed satisfactorily by the Commission; instead the costs rejected on the assumption that they are unique to the maintaining of a credit rating. The rationale for rejecting these costs appears flawed as these costs are incurred whether a credit rating is obtained or not.

Principle for determining debt issuance costs

290. As HoustonKemp explains in its report,⁹⁷ the Commission should provide an allowance for debt issuance costs that recovers all costs expected to be efficiently incurred by a supplier

⁹⁶ Houston Kemp, "Report for Powerco: Comment on the Commerce Commission's cost of capital update paper" (5 February 2016).

⁹⁷ HoustonKemp, "Issues raised by the Commerce Commission in its draft decision on cost of capital" (3 August 2016), at section 2.1.

acting consistently with the Commission's financing assumptions. This principle is reasonable and promotes the objectives in section 52A of the Commerce Act in that it:

290.1 provides incentives to invest by ensuring that the efficient costs associated with raising capital to fund investment are recovered; and

290.2 provides incentives for efficient debt raising practices by setting a benchmark level of compensation unconnected with costs.

291. This principle is also consistent with the Commission's objective of maintaining a 'simple' approach to determining the cost of debt.

292. It follows that any debt issuance cost that a supplier would efficiently incur if it were acting in accordance with the Commission's own financing assumptions should be recoverable, including:

292.1 costs required to be incurred in issuing a bond, including:

- (a) fees paid to arrange and market the issue;
- (b) fees for legal advice;
- (c) registrar fees; and
- (d) costs associated with discounting the issue price of a bond in order to attract investors, where this is otherwise not captured in the Commission's estimate of the cost of debt;

292.2 costs required to obtain and maintain a credit rating of BBB+, including:

- (a) fees paid to credit rating agencies; and
- (b) costs required to comply with requirements commensurate with a credit rating of BBB+.

Debt issuance costs

293. The Commission recognises that fees and costs associated with prudent debt issuance and refinancing costs are legitimate expenses that should be compensated for.⁹⁸ The current IMs provide an allowance of 35 basis points (**bps**) per annum. for prudently incurred debt issuance costs. The Commission is proposing that this allowance should be no higher than 20 bps per annum.

294. The Commission has indicated that evidence from its 2010 and 2016 debt surveys, submissions from industry participants,⁹⁹ and considerations of the High Court suggest the current allowance of 35 bps per annum. is generous.¹⁰⁰

295. Powerco does not agree with the Commission's proposed reduction to this allowance. In our view the information the Commission has used to assess current market levels of debt issuance costs has been poorly sourced and too great a reliance has been placed on a

⁹⁸ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [218].

⁹⁹ For example, Contact: "Submission on cost of capital update paper: 30 November 2015" (5 February 2016).

¹⁰⁰ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [243].

small sample of incomplete data. In the case of Contact's submission, the narrow selection of information used has influenced the Commission's findings.

296. We and HoustonKemp have identified the following issues with the Commission's approach to estimating debt issuance costs:¹⁰¹

296.1 The breadth of information requested by the Commission in its confidential debt survey is unnecessarily narrow. When completing the confidential debt survey, Powerco added columns of data to the response to provide the Commission with the complete picture of costs. In our view the narrow scope of information requested has resulted in the Commission using incomplete information to inform its findings. More particularly:

- (a) the template does not ask respondents for detailed information about debt issuance costs. It simply asks for "debt issuance costs" of a one-off or ongoing nature, without clarifying what categories of costs respondents should include in those fields. Given the potential for a variety of debt issuance costs to be incurred, it appears likely that this question will attract a range of responses, some of which will capture more categories of debt issuance costs than others; and
- (b) the Commission asks for debt issuance costs that are "not already captured" in the interest rate. However, the Commission does not ask for any information that would enable it to identify what part of debt issuance costs are captured in the interest rate, and to ensure that these are captured in the estimate of debt issuance costs that it reports from the survey.

296.2 In adopting the 'simple' approach for determining debt issuance costs the Commission has focused on bond issues. However there are few bond issues undertaken by New Zealand regulated entities meaning the data set from the confidential survey relating to bond issues is small. This small sample raises questions as to whether a reliable benchmark estimate can be formed.

296.3 The Commission's exclusive use of wholesale corporate bonds denominated in New Zealand dollars is inconsistent with the actual debt raising practices of New Zealand businesses. Powerco, like other businesses, issues both Retail Bonds and Wholesale Bonds. More recently it has issued Wholesale Bonds, taking advantage of a limited available market at opportunistic times. It is not conceivable that Powerco, or any entity, could continue to fund itself solely in the Wholesale Bond space, and so the higher costs associated with a Retail Bond will be borne.

296.4 The Commission has referenced evidence from Contact regarding debt issuance costs.¹⁰² In our view the costs presented are misleading. Contact submitted data that showed the cost of issuance before and after the cost of brokerage (the fee paid to brokers to distribute a bond to retail investors). The Commission has surprisingly chosen to publish the non-brokerage cost which is estimated by Contact to be 5.7bps per annum. In contrast Contact's estimate of the cost of issuance including the cost of brokerage is 15-25bps per annum. We consider that brokerage costs are legitimate cost incurred in raising debt, and should be compensated for.

296.5 In Contact's data set it points to the small number of issues that paid brokerage, but this is a disingenuous argument, as the non-brokerage issues are for higher rated

¹⁰¹ HoustonKemp, "Issues raised by the Commerce Commission in its draft decision on cost of capital" (3 August 2016), at section 2.4.

¹⁰² Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [226].

entities, where they do not require the distribution channel afforded by the broker network. We suggest that Contact's recent experience of a non-brokerage deal is an aberration, due to the time of issuance – Contact was wise and prudent to take the risk of a non-brokerage deal at the time, however it would have to attest, as would all bond arrangers, that today, and at most times, a non-brokerage paying issuance is not possible for a BBB+ rated entity.

- 296.6 Supporting this fact is the data set Contact provided, which shows that of the three BBB+ rated issues, only Contact's opportunistic issue avoided brokerage costs.
- 296.7 Powerco submits that the data provided by Contact has not been clearly interpreted, and that Contact's submission, when the data is observed correctly, supports a higher debt issuance costs associated with a New Zealand corporate bond.
- 296.8 Below we provide a breakdown of the reasonable costs associated with issuing a \$100 million five-year New Zealand Retail Bond issue. This information is based on both Powerco's experience, the experience of other corporate issuers, and advice from the two largest arrangers of Retail Bonds in New Zealand. This information is readily verifiable, and Powerco would be pleased to assist the Commission to confirm these facts:

Upfront Costs		\$	p.a.
Brokerage	0.75%	750,000	0.150%
Arranger/Syndicate fee	0.30%	300,000	0.060%
Legal		200,000	0.040%
Printing/Roadshow		40,000	0.008%
Advertising		4,000	0.001%
Registry		40,000	0.008%
Trustee & NZX		40,000	0.008%
S&P	0.06%	62,500	0.013%
Total Upfront Costs		1,436,500	0.287%
Ongoing Costs			
Registry		20,000	0.020%
Trustee		10,000	0.010%
NZX		10,000	0.010%
Total Ongoing Costs		40,000	0.040%
All-in		1.437%	0.327%

Recovery of debt hedging costs

297. The Commission has indicated that evidence from the 2016 confidential debt survey suggests the costs of executing a swap transaction in New Zealand is approximately 2bps per annum.¹⁰³
298. Powerco believes that the validation undertaken to discern the cost of swap transactions has not been fulsome, and its conclusions are erroneous as a result.

¹⁰³ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [239] – [240].

299. Contact, for example, has submitted that its “experience, confirmed by a survey of other Gentailers, is that the actual swap spread cost observed in practice is between zero and 2.5 basis points”.¹⁰⁴ We point out that the cost referred to by Contact is the cost of swapping a fixed rate bond at issue to a floating interest rate, to allow for efficient and prudent interest rate risk management practices in the future. Therefore, this estimate ignores the cost to ‘refix’ the floating rate debt. At a minimum the swap costs are clearly double.
300. In addition, it is undeniable that the New Zealand financial markets are comparatively small by international standards. When a large amount of hedging is required, for example in matching a regulated supplier’s interest cost to the regulatory cycle (‘regulatory hedging’), unavoidable liquidity constraints will result in further costs of hedging being reasonably incurred. These costs are known as the credit and execution charges.
301. Swap providers are required to maintain capital to support their financial market positions, and this capital incurs a credit charge, which is passed onto entities hedging. When a large amount of hedging is being undertaken these charges increase, as the small size of the New Zealand markets limits the competitive abilities of swap providers. The allowance for the cost of executing a swap transaction should recognise the full scale of credit charges.
302. In addition to credit charges, it is the requirement for a swap provider to pass onto an entity as an increased charge, compensation for the risks borne when executing swaps. A large transaction may not be able to be cleared in the small New Zealand financial markets, and so the provider, having set the price it gives the hedging entity, will take on the risk that across the subsequent period that it clears the transaction, markets move in adverse direction that increases the cost of the transaction. We consider that this compensation for execution risk paid by debt issuers to swap providers is a legitimate and prudently incurred cost that should be compensated for.
303. In Powerco’s experience credit and execution costs, taken together, can be as high as 10bps in addition to the swap interest rate. If a regulated supplier undertakes regulatory hedging to prudently match its interest costs to the regulatory cycle, then this 10bps is a per annum charge over the entire amount of a regulated supplier’s debt.
304. Powerco accepts that these costs vary from entity to entity and from time to time, and that past experience may not be a useful guide to future costs. Therefore we submit that the Commission could survey regulated suppliers more clearly to ascertain these costs. We do not believe this information was adequately requested in the most recent debt survey.
305. In addition, the Commission could invite advice from the four trading banks operating in New Zealand, to assist it in determining the costs of credit and execution associated with swap included debt issuance, and separately for hedging transactions. The banks are disinterested parties to the regulatory setting, and their independent market advice would be useful in understanding the true cost of swap transactions.

Additional costs of debt not addressed by the Commission

306. In Powerco’s previous submission, we submitted that the Commission’s estimate of the cost of debt should include additional costs that are unavoidably incurred by an efficient

¹⁰⁴ Contact Energy, “Submission on cost of capital update paper: 30 November 2015” (5 February 2016), at p 10.

debt issuer, and that are not currently recognised in the IMs.¹⁰⁵ The Commission has not addressed these points raised by Powerco, being:

306.1 the costs of maintaining debt facilities in excess of current debt requirements ('headroom'); and

306.2 the cost of refinancing debt in advance of the maturity date, and therefore sustaining a period of overlapping debt issues, and so incurring the cost of effective double funding of debt for a period; the cost of which is referred to as the 'cost of carry'.

307. Powerco presented these costs together as being those associated with maintaining a credit rating. The Commission's draft decision posited that "a S&P credit rating is not necessarily required to issue New Zealand domestic bonds".¹⁰⁶
308. Powerco agrees this is factually correct, but dismissing the need for the credit rating does not address the indisputable fact that these costs are still unavoidably incurred if a regulated supplier wishes to issue a bond. As HoustonKemp explains in its report, it is consistent with the Commission's simple approach, and the efficient debt issuance costs principle, to allow for the efficient costs of obtaining and maintaining a credit rating of BBB+. This is because the Commission's assumption that debt is raised at a rating of BBB+ is important to the Commission's determination of the cost of debt: it determines the sample of bonds that the Commission reviews in determining the debt premium. In HoustonKemp's opinion, it is not reasonable to determine the cost of debt under an assumption that maintains a credit rating of BBB+, but then to set aside costs that are efficiently incurred to achieve this.¹⁰⁷
309. We also note that the position the Commission is adopting is internally inconsistent, as it also states that "an efficient operator would seek to maintain an appropriate investment grade credit rating".¹⁰⁸
310. Whether a credit rating is obtained or not is irrelevant though to the validity of Powerco's argument; that these costs are unavoidable and should be included in the cost of debt allowances.
311. The obtaining and maintenance of a credit rating replaces the need for each investor to undertake, on their own, a large and unwieldy piece of due diligence on an issuer. In short, the investor can rely on the fact that the credit rating agency has performed industry standard tests of a bond issuer's ability to prudently manage liquidity risk and refinancing risk.
312. We note that Powerco has made no request for recognition of the annual cost associated with maintaining a credit rating, as this is at a detail level not significant to this argument.
313. If a regulated supplier has not obtained and maintained a credit rating, then each investor would have to assume, or more likely test, that the issuer has in place adequate policies, histories and financial backing to a standard that would otherwise qualify it for a suitable credit rating.

¹⁰⁵ Houston Kemp, "Report for Powerco: Comment on the Commerce Commission's cost of capital update paper" (5 February 2016).

¹⁰⁶ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [232].

¹⁰⁷ HoustonKemp, "Issues raised by the Commerce Commission in its draft decision on cost of capital" (3 August 2016), at section 2.3.

¹⁰⁸ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [250].

314. It is apparent that not maintaining a credit rating does not relieve the regulated supplier of the need for such financial prudence as maintaining liquidity headroom in its debt facilities and for refinancing maturing debt ahead of time.
315. Powerco stands by its original submission and encourages the Commission to address the proposal that these costs are included in the cost of debt allowance, rather than consider them as being solely related to obtaining and maintaining a credit rating.

New issue premium

316. Contrary to the Commission's findings,¹⁰⁹ we consider that there is evidence of an existing new issue premium for New Zealand denominated bonds. To this end, HoustonKemp analysed the available evidence and reached the following conclusion:¹¹⁰

The results of our analysis suggest that a new issue premium... exists for these bonds, and that its value is approximately 10 to 12 basis points, based on information sourced from a large number of bonds issued in New Zealand dollars, issued by companies domiciled in New Zealand.

317. We support HoustonKemp's findings in relation to this matter.

6.3. Adjustment to asset beta

318. Currently, the Commission includes an adjustment to the asset beta for GPBs. The Commission is now proposing to make no adjustment. HoustonKemp has analysed the Commission's reasoning for declining to make an adjustment to asset beta and has concluded that the Commission's reasons do not support its ultimate conclusion. HoustonKemp's overarching concern is that the Commission adopts two inconsistent positions in relation to its assumptions about overseas evidence on income elasticity of demand and systematic risks. The Commission:

318.1 rejects reliance upon HoustonKemp's empirical estimates of the ratio of income elasticity of demand for gas to the income elasticity of demand electricity in New Zealand by comparing HoustonKemp's results to evidence sourced from overseas markets; but

318.2 assumes otherwise that it has no knowledge of the relative systematic risks between electricity and gas businesses in New Zealand as against those overseas.

319. These positions are inconsistent because the Commission's rejection of HoustonKemp's results was founded upon an implicit assumption that income elasticities in New Zealand were comparable to those of overseas markets – in particular the United States. However, the Commission has no basis upon which to make this assumption, as is reflected in its subsequent questions about the relative systematic risks between New Zealand suppliers and firms in its asset beta sample.
320. Conversely, there is evidence that supports the direction of the results emerging from HoustonKemp's empirical analysis of income elasticities of demand in New Zealand. In particular, HoustonKemp's results are supported by qualitative analysis of gas consumptions patterns in New Zealand, as well as empirical estimates of income elasticities in Australia. The Commission's reasons for rejecting HoustonKemp's empirical analysis are not convincing.
321. We refer to HoustonKemp's detailed analysis in section 3 of its report.

¹⁰⁹ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [250].

¹¹⁰ HoustonKemp, "Issues raised by the Commerce Commission in its draft decision on cost of capital" (3 August 2016), at section 2.5.

6.4. Additional cost of capital issues

Incentives to apply for a CPP

322. Powerco agrees with the Commission's analysis of the problems arising from having a CPP-specific WACC, and the Commission's proposed solution. As the Commission is aware, this is an issue that has particularly impacted Powerco in recent years. We appreciate the time and care the Commission has given to defining and solving this issue.

Problem definition

323. We agree with the Commission that:
- 323.1 divergence between the DPP WACC and the CPP WACC creates perverse incentives for a supplier to either apply or not apply for a CPP;¹¹¹
 - 323.2 this is not in the long-term interests of consumers, because it means a CPP application is made at a sub-optimal time. Timing will not reflect the underlying network and service issues, but the short term interest rate environment;¹¹²
 - 323.3 if the CPP WACC is below the DPP WACC the supplier has a strong incentive not to apply for a CPP that would otherwise be in the long-term interests of consumers. This is a function of the size of the current RAB compared to forecast capex.¹¹³

Proposed solution

324. We agree with the solution proposed by the Commission. This is the approach we have recommended in previous submissions.¹¹⁴ The essential change is to one single WACC that at any point in time applies to all suppliers, whether they are on a DPP or a CPP.
325. To implement the approach, we agree with the Commission that the changes include the following:
- 325.1 Remove the requirement for a CPP specific WACC;¹¹⁵
 - 325.2 Make clear that the WACC determined for a five year period for the purposes of a DPP also applies to any CPP determination made during the five year period;¹¹⁶
 - 325.3 If a new DPP WACC is determined part way through a CPP period, the CPP is reopened and prices for the remainder of the CPP period are adjusted;¹¹⁷
 - 325.4 The adjusted prices are to be consistent with:
 - (a) the allowed return on capital over the remainder of the CPP period being equivalent to the new DPP WACC;¹¹⁸ and
 - (b) the new forecast of CPI used for the purposes of the DPP reset.¹¹⁹

¹¹¹ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [493].

¹¹² Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [494].

¹¹³ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [495].

¹¹⁴ Powerco, "Scope and process for fast track amendments to the CPP input methodology requirements" (5 February 2016), at p 2.

¹¹⁵ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [500].

¹¹⁶ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [500].

¹¹⁷ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [500].

¹¹⁸ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [500].

326. This approach will mean that fluctuations in interest rates will not be a significant consideration in a supplier's decision to apply for a CPP.¹²⁰
327. We agree with the Commission's decision to separate the resolution of these perverse incentives from the distinct question of whether the approach to setting the WACC introduces too much volatility.¹²¹ Powerco agrees there is an issue to be considered here, but this can be resolved separately and any resolution applied to the single WACC used for both DPP and CPP purposes.
328. We also agree with the reasons given by the Commission for not adopting the alternative solution of a dual WACC.¹²² While the Commission is correct to observe that in theory such an approach could be written into regulation and applied, we continue to believe that it would give rise to significant, compounding complexities (and, as with any complex regulation, introduce other unforeseen perverse incentives).
329. Some of these complexities were discussed in our previous submission and are identified by the Commission:¹²³
- 329.1 Separately identifying the CPP and DPP capex;
 - 329.2 Dealing with other areas of regulation that use a single WACC as an input (for example, in the IRIS mechanism);
 - 329.3 Considering how subsequent changes to the WACC are implemented once different assets are subject to different WACCs.
330. We are confident that the Commission is right to judge that the cost and complexity of this approach will outweigh the modest improvement in incentives on a relatively small amount of capex.¹²⁴ In our view, the solution proposed by the Commission addresses the perverse incentives currently operating on suppliers considering making CPP applications that would otherwise be in the long-term interests of consumers.

Leverage

331. We were disappointed with the Commission's proposal to revisit the notional leverage. Our understanding of the Commission's approach to this review was that the Commission would not revisit elements of the IMs without clear evidence that the current settings were failing to achieve the legislative purpose. Specifically, we understood that the Commission would refrain from 'tinkering' and that suppliers were invited to exercise similar restraint. In responding to the Commission's various consultation papers, Powerco has borne in mind the importance of not unnecessarily relitigating issues that were considered and effectively settled in the course of the 2010 consultation process and the subsequent appeal. Hence, we have limited our submissions to genuinely fresh issues, or matters on which we think there is something substantially new to say.
332. In our view, the adjustment to leverage is an example of unnecessary tinkering. We do not think the Commission was required to revisit leverage and that retaining the estimate arrived at in 2010 would have been a principled approach. Refreshing the estimate gives a false sense of precision given the acknowledged flaws in the methodology for estimating

¹¹⁹ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [501].

¹²⁰ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [502].

¹²¹ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [504].

¹²² Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [509] – [515].

¹²³ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [513].

¹²⁴ Commerce Commission, "Topic paper 4: Cost of capital issues" (16 June 2016), at [515].

WACC. Accordingly, to adjust a WACC parameter without clear evidence that the current value is not principled or does not serve the legislative purpose is inappropriate.

333. Furthermore, we do not think the Commission adequately signalled this change. By our reckoning, the only material reference to updating notional leverage appeared in paragraph 2.45 of the Commission's 30 November 2015 cost of capital update paper. That reference did not, we think, make it sufficiently clear that the Commission intended to adjust the notional leverage in a manner that would have a substantial financial impact on suppliers.

7. Topic 7: Related party transactions

7.1. Summary

334. The Commission's policy intent behind its approach to related party transactions is to ensure such arrangements cannot be manipulated by regulated suppliers to allow them to extract excessive profits. We agree with the Commission that this correctly states the policy objective behind the regulations.
335. In its paper, the Commission notes that a problem definition (if any) has not yet been formulated, and it intends to update interested parties later this year. And, unlike its other topic papers, *Topic Paper 7: Related party transactions* poses questions for submitters to consider in order to assist the Commission's understanding of related party transactions, and any associated issues.
336. We endorse the ENA's submission on this matter.¹²⁵
337. Powerco considers the Commission should carefully consider the relationship between related party trends and whether there is an actual, identifiable problem. This is not to say that we consider that a problem exists or otherwise; rather, we caution against the Commission attempting to fix the regulations for related party transactions if they are not broken.
338. Likewise, the Commission should ensure that it fully understands the drivers behind the emerging trends in related party transactions before proposing solutions.
339. To that end (and as suggested by the ENA), we recommend a sensible first step would be to hold industry workshops to better understand whether there is in fact an issue.¹²⁶
340. We look forward to engaging with the Commission further on this matter, particularly once it has reached a view on whether there are problems associated with the current approach to related party transactions.

¹²⁵ ENA, "Submission on IM Draft Decision Related Parties Paper" (4 August 2016).

¹²⁶ ENA, "Submission on IM Draft Decision Related Parties Paper" (4 August 2016), at [15].

8. Proposed minor amendments

Issue	Commission's proposal	Powerco's comment	Suggested action
<p>Allocating not directly attributable costs</p> <p>(Report on IM Review, CA02, point 382)</p>	<p>The Commission does not propose changing the cost allocation rules as such – i.e. still have ABAA, ACAM and OVABAA. The ACAM threshold test will move from unregulated income of 20%, to 10% of total income. The Commission has signalled it is going to amend the ID Determination to require information on unregulated revenue so it can “determine whether” suppliers are “permitted to use the ACAM approach by virtue of being under the Regulated Revenue Materiality Threshold.”</p>	<p>Powerco agrees in principle that the Commission may find it useful to receive information on the percentage of unregulated income included in total income for the EDB or GDB in order to confirm the ACAM threshold. Powerco does not agree that this information should be publicly disclosed and looks forward to commenting further in the IDD review.</p>	<p>Powerco will provide further comment on the IDD review.</p>
<p>Commissioned assets added to RAB</p> <p>(Report on IM Review AV06)</p>	<p>(As per the existing IMs) EDBs and GPBs should include assets in RAB at cost in the year in which the asset is commissioned, that is, when the asset is first used by the regulated supplier to provide electricity distribution services/gas pipeline services. The Commission has advised that it does not intend to change this.</p>	<p>This approach is problematic for assets such as ducts, which may be cost-effectively installed (i.e. as part of public work, etc) several years before being commissioned. Not including these assets in the RAB from their creation is likely to have cash flow implications for suppliers. The interest during construction allowance that is expected to compensate EDBs/GDBs for the holding costs during the construction phase follows GAAP. Therefore, interest during construction does not cover the period post construction but prior to commissioning. When assets may be held for several years the EDB/GDB is unable to recover the full costs incurred.</p>	<p>The Commission should allow assets installed prior to commissioning date to be included in the RAB at the time of their creation, as opposed to when they are commissioned. Alternatively, the interest during construction allowance could be extended to cover periods between construction and commissioning where the EDB or GDB could establish, to the assurance of its auditors, that the early construction of assets was prudent.</p>
<p>Easement rights</p> <p>(Report on IM Review, AV08)</p>	<p>(As per the existing IMs) EDBs and GPBs must include new easement rights in the RAB value at cost in the year in which the rights are acquired, provided that the RAB value of new easement</p>	<p>It would be useful if the IMs were updated to reflect the reasons paper to avoid confusion and possible disagreement with auditors who view the legal document to take precedence over the guidance</p>	<p>The Commission should update the IMs to reflect its reasons paper.</p>

rights does not exceed fair market value, as determined by an independent valuer. provided in a reasons paper.

Potential IRIS error identified by Dr Lally
(Report on IM Review, p 145, at [445 – 449])

As described by Dr Lally:
“...the Commission’s approach to opex is consistent with the NPV = 0 principle but inflation forecasting errors arising from opex raise prices by more than the inflation shock because inflation forecasting errors are compensated for twice. This would appear to be a design error.”
The Commission considers that the additional complexity to implement this fix does not seem to outweigh the benefit of doing so, given the opex incentive rate is only an estimate in any case (ie, it is currently 34%, based on a 5-year retention of permanent savings, but this changes with the WACC).

Retaining this calculation exposes EDBs to the risk of inflation forecast error and can result in an IRIS incentive adjustment that compromises real financial capital maintenance (FCM).
To illustrate this point, consider a capex allowance being set in real terms at \$100 for one disclosure year with a forecast CPI inflation allowance of 2%. The nominal allowance is therefore \$102. An EDB spends actual capex of \$103 and actual CPI inflation for the year is 3%. In real terms, the EDB has spent \$100 which is exactly the same as its allowed capex in real terms. However, in simple terms, the capex incentive will penalise the EDB \$0.15 (15% x (102-103)) for what is deemed to be an inefficient overspend. From an FCM perspective, allowed revenue in the year is adjusted for actual inflation so it is increased by 3%. Without the capex incentive then capex is the same in real terms as the capex allowance and the same in nominal terms as the revenue allowed to compensate for capex. ROI is therefore preserved in real terms and the EDB is compensated for actual inflation.
Introducing recoverable costs arising from the capex incentive results in ROI being eroded due to the \$0.15 penalty and Financial capital is not maintained in real terms.

The Commission can solve this problem by restating the determined opex and capex allowances in real terms (an amendment to the 2015-2020 EDB DPP Determination) and changing the IMs to use these amounts + the actual CPI inflation rate in calculating the incentive amounts.
Powerco considers this solution is straightforward, and would not (as the Commission suggests) be too complex or costly to implement.

341. If you wish to discuss this submission please contact Richard Fletcher, at richard.fletcher@powerco.co.nz. or on (04)978 9910, in the first instance.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R Fletcher', written in a cursive style.

Richard Fletcher
General Manager Regulation and Corporate Affairs