Submission to the Commerce Commission

on

Input methodologies review

Emerging views on form of control

24 March 2016

Introduction

1. We welcome the opportunity to submit on the Commerce Commission's consultation paper *Input methodologies review - Emerging views on the form of control* (Emerging Views paper).
2. No part of our submission is confidential.

We do not support the implementation of a pure revenue cap

3. We do not support the commission's emerging view that a pure revenue cap would be a more appropriate form of control for electricity distribution businesses (EDBs) than the weighted average price cap (WAPC). We are not convinced that changing the form of control would inherently address the three key problems identified by the commission in its Emerging Views Paper that under a WAPC:
    i) suppliers are exposed to the quantity forecasting risk
    ii) there is a disincentive to pursue energy efficiency and demand-side management incentives
    iii) there is a compliance risk when restructuring tariffs.

Exposure to quantity forecast risk

4. The primary reason for a change in the form of control appears to be a problem with the way in which the quantities forecasts are constructed under the default price-quality path (DPP)[1]. The problem as we understand it is that where an EDB has declining quantities that EDB is not able to earn a normal return.

5. While we do not disagree that an EDB being unable to earn a normal return is a significant problem and should be addressed, but we are not convinced that the WAPC in its self is the cause of the problem. Nor that changing the form of control will by default address the problem. Rather, we are of the view that the basis on which the DPP is set, including forecasts should be the commission's focus.

Disincentive to pursue energy efficiency and demand-side management

6. The problem is that a EDBs' quantities will decrease overtime where enough consumers exercise energy efficiency or where EDB increases demand side management over the norm.

7. Consumers are incentivized to exercise energy efficiency to reduce their overall electricity bill, through incentive programs (e.g., sponsored insulation), or simply because they believe it is the right thing to do. An EDB is incentivized to practice demand side management to avoid transmission peaks, thereby decrease transmission charges, or to manage capacity constraints on its network.

8. The disincentive for EDBs to either encourage energy efficiency or to manage demand arises because the allowable revenue calculation under the DPP does not have a mechanism in place to enable EDBs take account for a decrease in quantities due to an incentivized change in demand.

9. In theory where demand decreases it will do so only over the short term and would then flatten. Costs would correspondingly decrease and also flatten overtime. Therefore it is 'fair' that under a WAPC over the long term prices decrease in line with the decreased costs.

10. In practice however for some EDBs quantities are decreasing at a constant rate over time but costs are not correspondingly decreasing. Accordingly, an EDB with declining quantities is not able to earn a normal return.

11. This problem is not a symptom of having WAPC as a form of control. Rather the problem is due to the compliance with the DPP being based on actual lagged quantities without any adjustment for a change in behavior without a corresponding

[1] Commerce Commission, Electricity Distribution Services Default Price-Quality Path Determination 2015, [2014] NZCC 33, 28 November 2014.

change in costs. The commission could change its compliance test without needing to change the form of control

Compliance risk when restructuring tariffs

12. EDBs are not prevented from restructuring tariffs under the DPP. Where a EDB restructures its tariffs and must use derived quantities to demonstrate compliance that EDB must include in its annual compliance statement:

    i) the methodology used to determine the quantities that correspond to each restricted price;

    ii) the forecast of the quantities to each restructured price, and the actual quantities

    iii) an explanation of the differences between actual and forecast quantities.[2]

13. The above requirements are a compliance test set by the Commission not an inherent characteristic of a WAPC as a form of control. If the compliance test is too onerous to meet, which we assume is the problem given that the Emerging Views Paper was light on what the problem was here, then the commission needs to consider its test not necessarily change the form of control.

A pure revenue cap also has its problems

14. At Attachment 2 of the Emerging Views Paper the commission lists some of the problems with a pure revenue cap as the form of control. The commission does not state how it might address these, but we assume that that discussion will come in subsequent papers.

15. Our key problem with the pure revenue cap is that that form of control does not encourage suppliers to connect new customers.

    'Under the revenue cap, suppliers will be willing to connect new customers until the cost of making new connections exceeds that implicitly provided for in the price path. There becomes a potential disincentive for suppliers to connect new customers at the point that the marginal net income form connections is negative[3]'.

16. A pure revenue cap would also not support a step change in expenditure to address a significant growth in demand from existing customers on the network.

17. As we see it the forecasting problem that is currently in the WAPC associated with declining quantities is simply being shifted and will be a forecast problem that will

[2] Supra n1, clause 11.8, page 21.
[3] Emerging Views Paper, footnote 33, Attachment 2, page 19.

now be associated with increasing quantities under a pure revenue cap. While EDBs that have declining quantities will be able to earn a normal return EDBs that are experiencing growth will be unable to earn a normal return.

18. The commission states in its paper that the pure revenue cap could include a wash-up for the overs/unders recovery mechanism which use out-turn quantities to adjust allowable revenue.[4] We suggest that a wash-up could equally be introduced to a WAPC to address the problem of forecast risk.

19. Under a pure revenue cap the commission stated that it 'could' implement an incentive for connection service.[5] We agree that the commission could, but we do not see the Emerging views paper as making a commitment that it will.

20. Both solutions might address the key problems of forecast risk however, without seeing the detail on how both or either might be implemented we cannot support the pure revenue cap.

21. The commission's Emerging Views paper is too light on how and pure revenue cap would solve either key problems i) and ii) making it again difficult for us to support a change in the form of control.

Look before you leap

22. We are of the view that the criteria that the commission has used to analyse the form of control at Attachment 2 of the Emerging Views paper is too narrow and is not a good basis on which to make a significant change to an input methodology (IM).

23. We are of the view that the commission needs to:

    i) conduct a more thorough review of the WAPC to define the problem

    ii) consider how the basis on which the DPP and/or the WAPC was set should change

    iii) only once it has completed i) and ii) should the commission look to changing the form of control as a means to address problems.

24. Leaping straight to a change of control without having done the above steps is likely to result in a form of control that creates different but equally inequitable problems, though that might be for EDBs other than those impacted currently.

[4] Supra n3, Attachment 2, page 17.
[5] Supra n3, paragraph 30.2, page 7.

Closing Comments

25. We hope that our submission is helpful to the commission. We are happy to discuss our opinions further with the Commission should it find it useful.

26. The main contact for this submission is:

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