



MAJOR ELECTRICITY USERS' GROUP

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By email to NPB@comcom.govt.nz

Dear David

Submission on Reset of Default Price-Quality Path for Electricity Distribution Businesses

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission discussion paper, "Reset of Default Price-Quality Path for Electricity Distribution Businesses," published 19th June 2009¹.

Overall approach

2. The proposed dual-path approach with a price and quality components is supported. There is a trade-off between the level of line service quality demanded by consumers and the price paid. The specification of the price and quality dual-path should reflect and reinforce incentives on Electricity Distribution Businesses (EDB) to manage this trade-off.
3. Consumers are interested in their own quality and price not that of the EDB as a whole. The discussion paper makes this point succinctly²:

"Consumers respond to the prices that they face, rather than to the revenues that firms make. Similarly, service quality is more important to consumers at an individual service level than on a whole-of-business basis."

4. Therefore MEUG submit the dual-path price and quality components need to be disaggregated for each major class of consumer (eg by voltage class in discrete networks).

Quality path

5. End consumers plan their electricity consumption and demand for line services in particular on, amongst other things, expectations of future reliability. Different classes of consumers have very different quality expectations. Remote rural consumers understand the difficulties of maintaining reliable power supply and plan accordingly. Manufacturers taking supply medium and high voltages expect very high reliability and build and run their businesses accordingly. The Default Price-Quality Paths (DPP) should differentiate SAIDI³ and SAIFI⁴ for different classes of consumer.

¹ Refer <http://www.comcom.govt.nz/IndustryRegulation/Electricity/PriceQualityPaths/20102015defaultpricepath.aspx>

² Paragraph 47

³ SAIDI=System Average Interruption Duration Index. A measure of the average time for which supply is off

⁴ SAIFI=System Average Interruption Frequency Index. A measure of how often consumers are affected by interruptions

6. Consumer expectations of future reliability are formed by a combination of factors such as:
- a) Prior experience in achieving quality standards (SAIDI and SAIFI).
The proposed DPP include these measures.
 - b) How rigorously the DPP quality threshold will be policed and breaches prosecuted to incentivise EDB to meet standards.

The Commission will not begin consultation on enforcement processes until next year, ie after the s.52P⁵ DPP Determination is published. MEUG suggest that when resetting DPP after finalisation of the Input Methodologies the Commission reconsider quality thresholds in light of work by that date on enforcement processes.
 - c) Confidence the EDB will implement Asset Management Plans (AMP).

The discussion paper considers monitoring of AMP performance is best managed through information disclosure requirements. MEUG suggest that when resetting DPP after finalisation of the Input Methodologies the Commission reconsider if an index comparing work forecast in an AMP against actual work could be incorporated as a quality threshold. Such an index would create stronger incentives on EDB to publish and achieve realistic AMP.
 - d) Quality performance and liability provisions in line contracts.

In separate submissions to the Electricity Commission MEUG has suggested model distribution pricing and contract terms and conditions should be mandated. This would include quality performance and liability provisions.
7. As noted in paragraph 2 of this submission, the quality and price paths are interrelated because of the quality-price trade-offs. One way to recognise this trade-off in a s.52P DPP Determination would be to allow a lower quality threshold provided consumers were compensated for loss of utility when unplanned faults occur. In other words an EDB that paid compensation at a level acceptable to the Commission would have a higher SAIDI/SAIFI threshold than an EDB that did not pay compensation. A quality path formula with and without a compensation payment provision could be considered.
8. In competitive markets suppliers must consistently meet quality standards demanded by consumers. Consumers have little tolerance for repeated poor performance. Consumers don't assess performance by excusing outlier results and accepting near-enough-is-good enough using a dead-band measure. Competitive businesses that fail to achieve quality standards but charge the same price as those that achieve standards quickly go out of business. The s.52P quality standard determination needs to be as demanding as that of competitive markets. Therefore either a mechanism to eliminate extreme variability (eg the IEEE 2.5 Beta Method) or a dead-band around the trend line should be used; but not both.

Maximum "Price" path

9. The discussion paper proposes the maximum price path will prescribe a formula based on maximum revenues. S.53M (1) (a) allows maximum price or prices to be regulated instead of or as well as revenues. Prices set by regulation are more likely to be efficient (ie cost-reflective) than prices EDB set under a revenue cap. The discussion paper notes⁶:

"Simply because prices result in regulated revenues that provide close to a normal return over time does not mean that they will minimise the allocative inefficiencies caused by departing from marginal cost-based prices. Allocative efficiency is more dependent on individual price levels and structure than on overall revenue ..."

⁵ This is shorthand for section 52P of the Commerce Act 1996 last amended 14th October 2008.

⁶ Paragraph 47

10. The experience of poor tariff structures and benefit of including the tariff re-balancing requirement in the Unison⁷ and Vector⁸ Settlements support this view.
11. Even though there is only 4 months remaining before a determination must be declared by Order in Council, there may be benefit in developing a maximum price path for every class of consumer for all EDB. MEUG suggest the Commission keep this option open because the benefits of having more cost-reflective prices may outweigh the cost of implementing a maximum price rather than maximum revenue DPP. Such maximum prices would be for generic consumer classes rather than for specific tariffs. The latter would go beyond the "relatively low-cost"⁹ and flexible attributes required of a DPP.

When to reset maximum revenues

12. The discussion paper proposes maximum revenues at 1st April 2010 be equivalent to those at 31st March 2010. After the Input Methodologies are finalised a reset and claw-back relative to 1st April 2010 can take place within 9 months as provided in s.54K. Because 4 months notice of a revised DPP is required, this leaves 5 months for the Commission to consider, consult and finalise changes after Input Methodologies are published. Where a reset for a particular EDB will clearly be needed, there are two problems with delaying that reset:
 - a) Between 1st April 2010 and until the reset, some or all of that EDB line services will be mispriced. Inefficient use of resources and investment decisions by both the EDB and its customers will occur because of this mispricing.
 - b) It is likely the Input Methodologies will be appealed. In that event maximum revenue resets might be delayed until the outcome of the appeals is known. This could be years; in which case line services will continue to be mispriced and the inefficient use and investment by EDB and consumers will continue.
13. MEUG suggests the cost of undertaking an initial reset where there is a material and clear differences between the threshold revenue and the new DPP path could outweigh the benefit of better pricing line services in the economy as a whole. With annual aggregate EDB costs measured in hundreds of millions it would take only a small change in costs due to more cost-reflective prices¹⁰ to offset the cost of a reset effective 1st April 2010 likely to be measured in hundreds of thousands of dollars. Any work undertaken now on the cost and profitability of EDB will also reduce the cost of having to review the DPP after the Input Methodologies are finalised. MEUG therefore recommend the Commission should assess at a high level whether there might be a material difference between threshold revenues and a DPP regime and if so then proceed to develop a P₀ reset on 1st April 2010. Any P₀ resets on 1st April 2010 could be a partial step change (up or down) on the path towards more efficient revenue levels, leaving scope for further changes in the direction of the initial reset after finalisation of Input Methodologies.

How to reset maximum revenues

14. The high level proposal to use partial building blocks analysis and standard WACC to assess current profitability is supported. Detailed comments on these will be made on the Input Methodologies and cost of capital guidelines consultation papers.
15. There should also be sufficient information in AMP to model forecast profitability. There are standard software packages available to model business valuations and the Commission has had experience with several Settlements and the Gas Control regime; so there should be no concern on completing this work over the next few months.

⁷ Unison Post-Breach Inquiry decision 11th May 2007, refer <http://www.comcom.govt.nz/IndustryRegulation/Electricity/ElectricityLinesBusinesses/TargetedControl/submissionsoncommissionsintention.aspx>

⁸ Vector Post-Breach Inquiry decision, 30th May 2008, refer <http://www.comcom.govt.nz/IndustryRegulation/Electricity/ElectricityLinesBusinesses/TargetedControl/vectorintentiontodeterminecontrol.aspx>

⁹ Refer s.53K titled "Purpose of default/customized price-quality regulation"

¹⁰ This example does not include the change in costs by consumers as a result of more cost-reflective pricing.

Price path

16. The amended Total Productivity Factor (TPF) formula is worth investigating¹¹.
17. Before ruling out use of international productivity data in the Determination formula¹², MEUG suggest the Commission undertake a more thorough analysis. Even if the outcome confirms the discussion paper view that finding comparable international data is likely to be difficult, the investigation might provide other insights for our regime.

Pass-through costs

18. Commerce Commission levies, Electricity Commission levies and Transmission Interconnection charges (this includes transmission loss and constraint rental rebates) are all set on a formula basis by statutory bodies that are required to promote, amongst other things, efficient outcomes. EDB cannot avoid these levies, though they can change the levy incidence. For example by changing peak demand coincident with regional capacity peaks will change Transmission Interconnection charges. These levies and charges are also unpredictable and could change materially over the next five years. For example Transmission Interconnection charges will increase as capital investment approved by the Electricity Commission comes into service. MEUG agrees these levies and charges can be treated as pass-through costs.
19. Local authority rating formulas differ between locations. If rates are not treated as a pass-through cost, then everything else being equal, EDB paying efficiently set rates will have a lower cost structure than EDB that subsidise other rating classes. There is also a complication that some local authorities may own an EDB they set rates for and hence could use the pass-through to increase rating revenues via line charges. Excluding rates as pass-through costs will create better incentives on local authorities and EDB to minimise rating costs.
20. Connection charges are EDB specific. Connection assets and EDB sub transmission assets can be substitutes. Connection charges are entirely manageable and predictable by the EDB. An EDB that mismanages timing, design and choice of Transmission New Investment Contract options with Transpower compared to an otherwise similar EDB, should suffer by either being less profitable and or paying the consequences of breaching contracted or DPP regulated quality standards. Therefore MEUG suggest transmission connection charges should not be treated as a pass-through cost.

S.54Q Energy Efficiency

21. MEUG agrees with the proposed consideration of s.54Q requirements in the information disclosure requirements. In choosing where to spend its resources, MEUG suggest the Commission has a number of other higher priorities to consider in developing DPP including the points raised in this submission.

Yours sincerely



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¹¹ Question 46

¹² Discussion paper question 45