

Customised price-quality paths

Presentation to MEUG

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Introduction



Outline

Today's presentation covers...

1. A brief introduction to Part 4
2. Overview of price-quality regulation
3. Customised price-quality paths (CPPs) – focus for today



Introduction to Part 4



Introduction to Part 4

Outline

- Purpose of Part 4
- Performance and incentives
- Regulatory tools



Purpose of Part 4

Section 52A of the Commerce Act...

To promote the **long-term** benefit of **consumers** [of regulated services] by promoting **outcomes** that are consistent with outcomes produced in [workably] competitive markets



Performance and incentives

Key performance areas we focus on...

Investment

Innovation

Efficiency

Quality

Pricing

Profitability

Regulatory tools

Regulation under Part 4

- Input methodologies
- Information disclosure (ID): all EDBs
 - Summary and analysis of ID data
- Price-quality regulation (PQR): 17 of 29 EDBs



Price-quality regulation



Price-quality regulation

Outline

- Purpose and content of price-quality paths
- Origins and history of the regime
- Relationship between DPPs and CPPs



Statutory purpose

Section 53K of the Act...

- Provides a relatively **low-cost** way of setting price-quality paths for regulated suppliers (ie, default customised price-quality paths, **DPPs**), while allowing the opportunity for individual suppliers to have alternative price-quality paths that better meet their **particular circumstances (CPPs)**



Content of price-quality paths

Statutory requirements

- Price-path
- Starting prices
 - Rate of change (CPI-X)
 - Pass-through and recoverable costs
- Quality standards and incentives
- Fixed period
- How compliance is assessed



Content of price-quality paths

Statutory limitations

- Must not seek ex-post recovery of excessive profits (claw-back, except in limited circumstances)
- Must not be set using comparative benchmarking
- Can only be updated mid-period in limited circumstances (described in Act and IMs)



Origin story

Before Part 4 was introduced

- From 2001 – 2008: 29 EDBs subject to now-repealed Part 4A - provided for Commission to set and administer performance ‘thresholds’
- Commission discretion led to uncertainty
- Current regime introduced to:
 - Tailor the regime to NZ’s small size
 - Provide incentives to invest etc.



Origin story

Idea behind DPP/CPP regulation

- CPPs (and Transpower's IPP) were conceptually similar to how PQ regulation works in UK and Australia – building blocks approach
- We originally thought we'd set DPPs using a low-cost 'banded ROI' approach
 - Subsequently concluded building blocks were preferable



Origin story

Progress of price-path setting

- Original paths set based on a roll-over in 2009
- First set under Part 4 approach in 2010
- Mid-period reset applying IMs in 2012 (TP & EDBs) and 2013 (GPBs)
- CPP for Orion in 2013
- Full resets in 2015 (TP & EDBs) and 2017 (GPBs)
- CPP for Powerco (on-going)



Default and customised paths

Relationship between DPPs and CPPs

- Spectrum of flexibility/tailoring

DPP → Pass-through/recoverable costs → DPP reopeners → CPP → CPP reopeners

- Proportionate scrutiny principle
 - We base levels of scrutiny on price/quality impact on consumers
- Certain plans go beyond what's possible under a DPP, but no 'bright-line'



Default and customised paths

Similarities

- Content of the paths are largely the same
- Common ‘expenditure objective’ used by Commission when assessing forecasts
- Following IM review, now a common cost of capital



Default and customised paths

Differences

- DPPs set for all PQ regulated suppliers, CPP only set following application from a supplier
- DPPs take a relatively low-cost approach:
 - Consistent approach across sector
 - Limited supplier-specific exemptions
 - Use of existing data (where possible)
 - No annual updating



Default and customised paths

Differences (cont.)

- CPPs allow for greater tailoring, but also require more scrutiny:
 - Specified information requirements
 - Audit, verification, consumer consultation
 - Merits appeal available
- Fixed timeline for decision making
- Regulatory period 3-5 years



Customised price-quality paths



Customised price-quality paths

Outline

- Contents of a CPP
- Objectives for CPPs
- Key process steps
- Areas for future consideration



Contents of a CPP

Supplier submits proposal, we determine price quality path

- Suppliers can propose uplifts solely to expenditure, or for both expenditure and quality
- For the **price path**, we use a building blocks approach to determine a starting price
- We also set **quality standards** to ensure suppliers have incentives to deliver services at a quality that meets consumer demand



Objectives for CPPs

We want CPPs to be a viable alternative to the DPP

- Suppliers have raised concerns about cost and uncertainty
 - The costs of application are a big step up from those under a DPP
 - A CPP application cannot be withdrawn
 - During the CPP period, a supplier cannot change a CPP
- We have made improvements to the regime aimed at reducing the costs associated with a CPP application
- We want to use Powerco's application to remove some of the uncertainty suppliers have

Objectives for CPPs (cont.)

Circumstances when applying for a CPP will be different

- Orion
- Powerco
- First Gas (potentially)
- Aurora (potentially)

Objectives for CPPs (cont.)

We see benefits of a CPP application go beyond the CPP period

- In preparing for a CPP, we expect business processes to improve and to become long lasting
 - However, no penalising for poor business processes where the investment need is obvious
- We expect the supplier's strategy underpinning a CPP proposal to be sustainable and sufficiently challenged internally
- We want to see this strategy being reflected in the expenditure proposals

Key process steps

Key process steps are designed to provide certainty

- **Consumer consultation** – testing consumers' views on expenditure proposals and acceptance of associated price increases
- **Verification** – providing pre-application challenge to the proposal with a view to guiding us in undertaking our own assessment
- **Our assessment** – by considering the outcome of the pre-application process steps, we will apply proportionate scrutiny in our assessment of the proposal. This includes focusing on the material aspects and taking a top-down approach to gaining assurance of the proposal

Areas for future consideration

We see various areas for future consideration

- Pricing
- Quality
- R&D
- Application costs

Important to recognise CPP process is constantly evolving

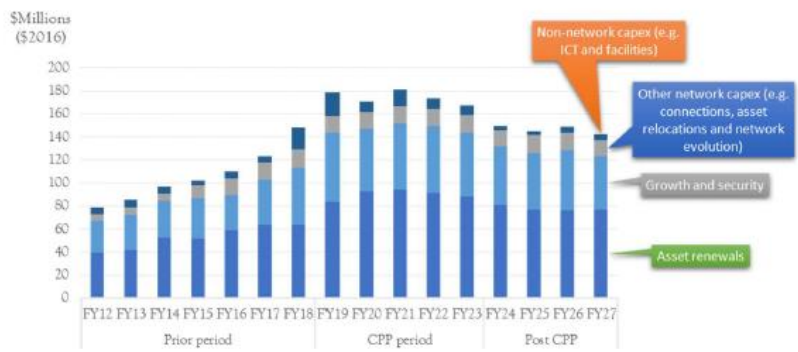


Snapshot of Powerco's CPP Proposal

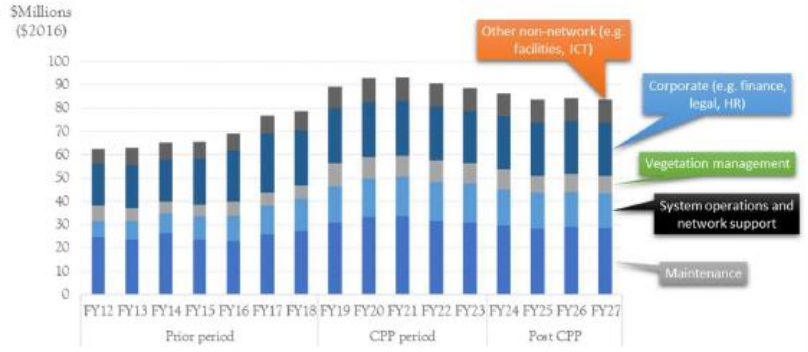
- Covers five year period from 1 April 2018 to 31 March 2023
- Requesting \$1,327.5m of capital and operating expenditures compared to \$936.9m for previous five years (\$2016 real)
- Increased revenues of 5.7% at start of period and rising annually in line with inflation for rest of CPP period. Alternative option of 'smoothing' revenue increases over CPP
- A 5.7% increase would add around 79c per week to typical household bill
- Proposal to keep level of unplanned outages at historic levels, but planned outages will increase

Snapshot of Powerco CPP Proposal

A: Proposed capex

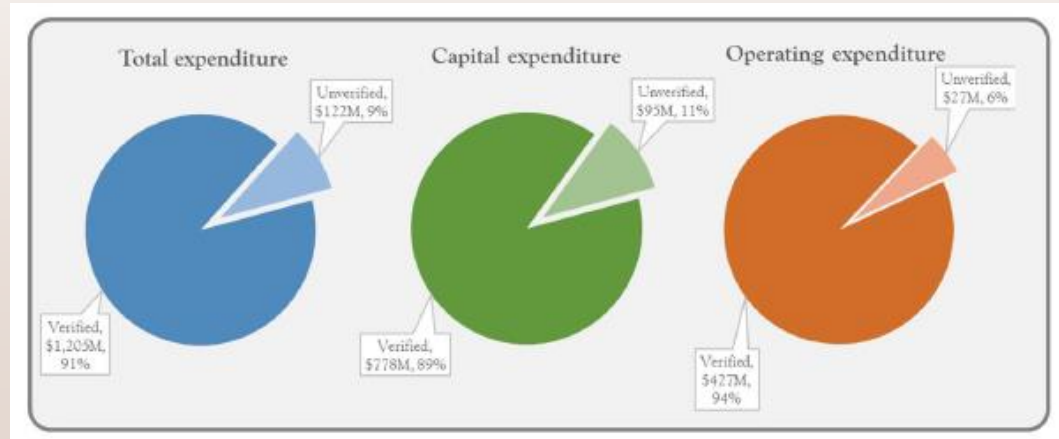


B: Proposed opex



What has the Verifier said

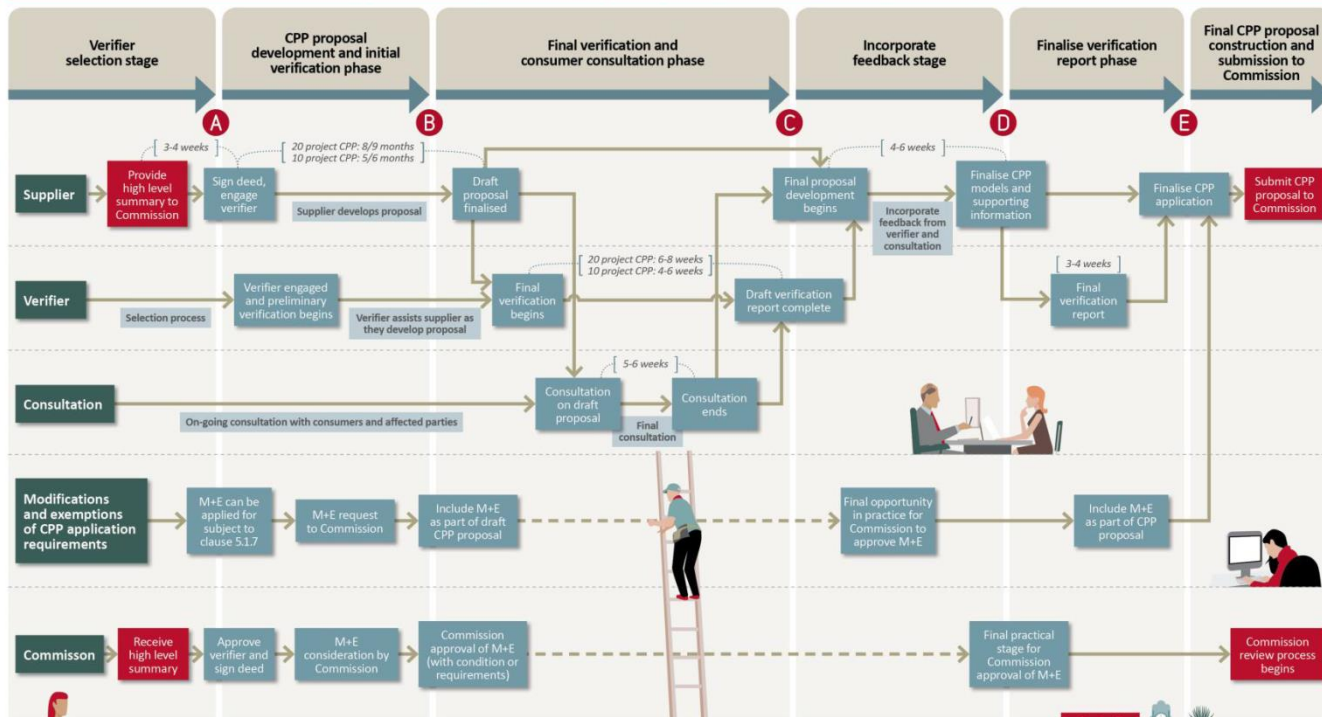
- Verification process has already resulted in Powerco downwardly adjusting its expenditure proposal (\$51.4m capex (5.6%) and \$21.3m opex (4.8%))
- The Verifier has recommended further areas the Commission should focus on



Some Key Dates for Powerco CPP

Process step	Date
Issues paper published	18 August 2017
Submissions due on Powerco's proposal	22 September 2017
Draft decision on Powerco's maximum revenues and required quality standards	17 November 2017
Submissions due on draft decision	15 December 2017
Cross-submissions due on matters raised in submissions on draft decision	19 January 2018
Final decision on Powerco's maximum revenues and required quality standards	29 March 2018

Indicative CPP application process diagram for EDBs



Suggested target dates:

20 project CPP: 8 months + 13-17 weeks = 12 months
 20 project CPP: A HLS to CC/Verifier starts _____ January
 B Draft proposal _____ end August
 C Draft verification report _____ mid October
 D Models and proposal finalised _____ end November
 E Final verification report _____ end December

Suggested target dates:

10 project CPP: 6 months + 11-16 weeks = 9/10 months
 10 project CPP: A HLS to CC/Verifier starts _____ February/March
 B Draft proposal _____ end August
 C Draft verification report _____ mid October
 D Models and proposal finalised _____ end November
 E Final verification report _____ end December

