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# Input Methodologies review – Topic paper 2, CPP requirements

Submission to the Commerce Commission

**Final**

From the Electricity Networks Association

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# 1. Introduction

1. The Electricity Networks Association (**ENA**) appreciates the opportunity to make a submission to the Commerce Commission (**Commission**) on the consultation **paper Input methodologies review draft decisions – Topic paper 2 – CPP requirements, 16 June 2016(CPP paper)**. This submission is supported by our forthcoming submission on the Draft Determinations, where we set out our recommendations for changes to the Draft IM Determinations for the CPP Input Methodologies (**IMs**); and our accompanying submission on the Report on the IM Review.
2. The ENA represents all of New Zealand's 26 electricity distribution businesses (**EDBs**) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network), electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

## 2. Submission Summary

### 2.1. Overview of the CPP paper

3. The ENA recommends that:
  - The Default Price-Quality Path (**DPP**) IMs are modified to increase the ways in which business specific circumstances can be accommodated in them.
  - The Customised Price-Quality Path (**CPP**) IMs are modified to reduce the cost and complexity of CPP applications and assessments, and to improve certainty for CPPs.
  - The CPPs IMs are more flexible, including incorporating the proportionate scrutiny principle, permitting alternative approaches with equivalent effect, and allowing for explicit consideration of the scale of the supplier.
  - The CPP evaluation criteria are retained and any explanations and requirements for assessing CPP proposals must be consistent with, and tied back to, these criteria. The ENA does not consider additional evaluation criteria are required.

### 2.2. Improvements to the way in which DPPs and CPPs work together

4. The ENA recommends that:
  - New CPP reopeners for contingent and unforeseen projects are adopted. In addition, if a revenue cap is introduced as the form of control we submit that a DPP reopener for unforeseen major connections is included.

- The quality standard only CPP option is removed and is replaced by a quality only DPP reopener, to be made available within the current regulatory period, and to be initiated by suppliers. We consider the proposed reopener process can be improved in a number of ways, as discussed in the body of this submission.
- If a weighted average price cap form of control is retained, a constant price revenue growth (**CPRG**) reopener is introduced.
- New DPP and CPP reopeners for workability issues including a ‘next closest alternative’ solution are introduced subject to some restrictions on when this can be applied and the Commission providing clarification of the proposed section 52Q reopener.
- New DPP and CPP reopeners for unforeseen consequences of major transactions are introduced as proposed, subject to limiting any adjustments to the impact of the transaction on the price path or quality standards.
- A new CPP reopener to accommodate the impact of a change in regulatory WACC which may occur during a CPP regulatory period is introduced as proposed. However the cost of debt assumptions used in the forecast regulatory tax allowance must also be updated to reflect the updated WACC.
- A new urgent project recoverable cost is introduced for CPPs as proposed, contingent on extending the DPP capex wash-up recoverable cost allowance to CPPs. This will align the DPP and CPP price path methodologies, by ensuring a CPP price path appropriately reflects the opening RAB at the beginning of the regulatory period.
- Pass-through costs for a forthcoming regulatory period may be specified as part of the determination as proposed.
- The recoverable cost allowances for costs incurred in applying for a CPP are expanded to include prudent abnormal costs incurred by the applicant in making the CPP application, because incurring these costs is in the long term interests of consumers.
- A new recoverable cost for engineering costs associated with a quality standard DPP reopener application is introduced as proposed, noting that the engineer’s report should be optional when applying for the DPP quality standard reopener.
- The proposal to apply DPP WACCs for CPPs is adopted because it addresses the incentive problem between DPPs and CPPs, removes a timing constraint in the CPP application process and is administratively simple to implement.

## 2.3. Evaluation of CPP proposals

5. The ENA recommends that:
  - The proportionate scrutiny principle is applied in assessing CPP proposals, and the Commission demonstrates in its decisions how its assessment is consistent with this principle.
  - The Commission considers alternative assessment approaches to improve effectiveness including retaining the verifier after a CPP application has been

submitted and workshops with the applicant. These approaches can further decrease the cost and complexity of CPPs by reducing the upfront burden on applicants to produce significant volumes of written material for a CPP application.

- All guidance and explanation about how the Commission will assess a CPP proposal is directly linked to the IM requirements. Additional and informal information requirements and assessment criteria introduced in consultation or decision papers only adds to the complexity and uncertainty of the CPP process.
- Supplier scale is explicitly considered when assessing applications for modifications and exemptions to the CPP requirements.
- The abnormal and prudent costs of preparing a CPP proposal are recovered through prices, to enable smaller suppliers to apply for a CPP when it is in the long term interests of their consumers.

## 2.4. Information requirements

6. The ENA recommends that:

- The CPP information requirements are modified to reduce cost and complexity and to better align with information disclosure (ID) requirements.
- An AMP-plus approach is adopted as proposed.
- CPP applicants are required to consider the deliverability of the proposed expenditure plan, at an aggregate level, but are not required to produce a 'deliverability report'.
- The proposal to clarify that price path models form part of the CPP proposal is further developed, by including the Commission's expectations about model information in the CPP IMs at clause 5.4.7.
- Unnecessary disaggregation of quantitative information is removed from the CPP information requirements, however:
  - the proposed capex and capital contribution information changes must be carried through into the asset valuation and regulatory tax building block methods in order for them to have any real impact on CPP compliance complexity; and
  - the proposals can be further improved for related party transaction information.
- Schedules B and C are updated to reflect the ID cost allocation schedules.
- Measures to increase flexibility in meeting CPP information requirements are introduced, including redrafting the information requirements for unit cost and expenditure escalators.

## 2.5. Verification requirements

7. The ENA recommends that:

- The verifier's terms of reference (TOR) is amended to define the verifier's role, purpose and obligations, but the proposed amendment is improved to remove ambiguity and better align with the remainder of the CPP IMs.

- The verifier no longer assesses non-standard depreciation, and in addition does not assess cost allocation which is more appropriately reviewed by the auditor.
- The proposal for the applicant to provide a high level summary of the CPP proposal to the Commission is removed, as it adds undue cost and complexity and it exposes the applicant to Commission scrutiny too early. Further the Commission has access to other information to help it plan and focus its assessment of a CPP proposal.
- A communication protocol is included in the verifier's tripartite deed.
- There is more flexibility for the verifier in selecting projects and programmes for detailed review, but the associated draft guidance is improved.
- An independent engineer no longer assesses a quality standard variation, to be included instead in the verifier's TOR but with more specificity than in the current draft.
- The verifier's review of the extent and effectiveness of the supplier's consultation with consumers does not include forming a view on the proposed price path or the trade-off between price and quality of service.

## 2.6. Audit requirements

8. The ENA recommends that the audit requirements are further amended to provide more clarity over the role of the auditor and the form of audit report to be issued.

## 2.7. Consumer consultation requirements

9. The ENA recommends that:
  - The IMs further clarify the expectations for consumer consultation on a CPP proposal.
  - CPP applicants are able to determine how best to consult with their own consumers.
  - Consumer consultation should not include consultation on price/quality trade-offs for all alternative investment options. Rather consultation should focus on alternative investment options which relate to the key reasons for CPP proposal.

## 3. Overview of the CPP paper

### 3.1. Overview

10. The CPP paper:

- Proposes improvement to the way in which DPPs and CPPs work together, including changes to pass through and recoverable costs and reopener provisions for CPPs and DPPs
- Proposes improvements to the CPP IMs based on experience with the first CPP proposal, including processes for preparing CPP proposals, and assessing and evaluating them
- Proposes improvements to the CPP IMs taking into account developments in information disclosures since the IMs were first set in 2010, including improvements to the CPP proposal information requirements
- Proposes improvements to the CPP IMs in how customised price- quality paths are determined.

11. In addition, it is proposed that the CPP specific WACC is removed, and the prevailing DPP WACC is applied in CPP price paths. The comments in this section are developed in more detail throughout the remainder of the submission.

### 3.2. Reducing cost and complexity

12. The majority of the changes proposed are targeted at reducing the cost and complexity, and improving certainty for CPP applications. In addition some of the changes proposed are intended to increase consideration of supplier-specific circumstances in DPPs. The ENA supports these high level objectives.
13. It is critical for the operation of Part 4 that the CPP is a viable alternative for non-exempt EDBs where the DPP is unable to fully accommodate their business specific circumstances. Currently the CPP IMs impose a level of costs on the applicant which are unreasonable and therefore act as a significant deterrent. This compromises the effectiveness of the DPP/ CPP regime.

### 3.3. Flexibility and scale

14. The ENA supports further consideration of how CPP processes can be more flexible, in order to reduce unnecessary cost and complexity for the supplier. Appropriate mechanisms include:
- Making best use of the supplier's own information by reducing the level of prescription in the CPP requirements
  - Applying the proportionate scrutiny principle when assessing a CPP application, including in respect of the scale of the supplier
  - Allowing alternative approaches to the CPP IM with equivalent effect, where appropriate
  - Aligning CPP information with ID information, where appropriate.

## 3.4. Assessing and determining a CPP

15. The CPP paper makes a number of observations about how CPPs are assessed and the expected areas of focus by the Commission, the verifier and the auditor. We understand that a CPP application will require a degree of scrutiny above that expected for a DPP, and that scrutiny will be influenced by the content of the CPP application. However the CPP IMs include a specific set of CPP evaluation criteria which are consistent with the overarching section 52A purpose of Part 4, while recognising that forecast demand, service levels and expenditure will be significant components of a CPP application. The CPP paper does not adequately recognise these overarching objectives.
16. The ENA cautions against introducing additional informal assessment criteria via the IM consultation and decision papers. Additional criteria are also evident in some of the proposed changes to the CPP IM Schedules. This outcome has, possibly inadvertently, increased the cost and complexity of CPPs and reduced CPP certainty. This is contrary to the objective of the CPP IM review.
17. For the avoidance of doubt, the ENA supports the intention to retain the CPP evaluation criteria (refer IM clause 5.2.1), which are fit for purpose. The ENA does not consider additional evaluation criteria are required. Accordingly we recommend that any explanations about how CPP proposals will be assessed (including the CPP information requirements) must be consistent with, and tied back to, the criteria in the IMs.

## 3.5. Recommendations

18. The ENA recommends that:
  - The DPP IMs are modified to increase the ways in which business specific circumstances can be accommodated in them.
  - The CPP IMs are modified to reduce the cost and complexity of CPP applications and assessments, and to improve certainty for CPPs.
  - The CPPs IMs are more flexible, including incorporating the proportionate scrutiny principle, permitting alternative approaches with equivalent effect, and making explicit consideration of the scale of the supplier.
  - The CPP evaluation criteria are retained and any explanations and requirements for assessing CPP proposals must be consistent with, and tied back to, the criteria in the IMs. The ENA does not consider additional evaluation criteria are required.

# 4. Improvements to the way in which the DPP and CPP work together

## 4.1. Overview

19. The CPP paper proposes:
  - New CPP reopeners for contingent and unforeseen projects

- That the quality standard only CPP option is removed and is replaced by a quality only DPP reopener
  - An expanded error reopener for DPPs and CPPs
  - New DPP and CPP reopeners for workability issues including a 'next closest alternative' solution
  - New DPP and CPP reopeners for unforeseen consequences of major transactions
  - A new CPP reopener to accommodate the impact of a change in regulatory WACC which may occur during a CPP regulatory period
  - That prudently incurred costs for a urgent project are able to be recovered in CPP price paths, where these costs are incurred between the time of the CPP application and the CPP coming into effect
  - That pass-through costs for a forthcoming regulatory period may be specified as part of the determination
  - That the recoverable cost allowances for costs incurred in applying for a CPP are unchanged
  - A new recoverable cost for engineering costs associated with a quality standard DPP reopener application.
20. In addition, the CPP paper identifies a proposed change to the CPP WACC. Our response to this proposal is included in sections 4.2.7 and 4.4 below.

## 4.2. DPP/ CPP reopeners

### Contingent and unforeseen projects

21. It is proposed that CPP reopeners are included for contingent and unforeseen projects. We support the proposal for CPPs, because there will be a substantial body of evidence underpinning the CPP price path and quality standards, against which the proposed contingent or unforeseen project can be assessed. In addition, these provisions recognise that it will not always be possible to accurately predict the demand for and timing of significant projects (which may be customer driven) when a CPP application is made.

### Quality standard

22. It is proposed that DPPs are able to be reopened for a quality standard variation, and as a result, the quality only CPP option is removed. We consider this proposal will improve the way in which DPPs and CPPs work together. It will reduce the cost and complexity in addressing inappropriate DPP quality standard determinations. We note a supplier is also able to propose an alternative quality standard in a CPP application.
23. The ENA submits that this reopener is made available immediately the IMs have been amended and the CPP option is removed. This is necessary to provide a mechanism for addressing issues with DPP quality standards prior to the next DPP reset.
24. We support the proposal that this reopener is able to be initiated by the supplier not the Commission. We see no justification for the Commission changing its view on the DPP quality

standards, other than where an error has been identified. This situation is adequately provided for in other reopeners.

25. The proposed process for the DPP reopener is:

- A proposal is submitted to the Commission which sets out the alternative quality standards, justification of them, analysis of the impact of the variation using historical data and demonstration of customer consultation on the proposed variation
- The proposal includes an engineer's report which considers statistical analysis and/or the level of investment in forecast allowable revenue
- The Commission may request further information.

26. The ENA submits that this proposed reopener process can be improved by:

- Updating the quality standard references to better reflect the changes which were introduced in the 2015 DPP Determination
- Removing the requirement for an engineer's report, but retaining the proposed content of this report and allowing the supplier to include this directly in the proposal. This will reduce cost and complexity. A supplier may choose to submit an engineer's report, but this need not be a prerequisite
- Setting out the criteria which the Commission will use to assess a quality standard variation proposal
- Acknowledging that the level of investment underpinning a supplier's forecast allowable revenue may not reflect the actual level of investment, or mix of investment (such as capex and opex) of the supplier. This is particularly relevant to a DPP, where the relatively low cost forecasting methods are unlikely to generate expenditure forecasts which align with the actual outcomes for a supplier
- Applying the alternative standards, once determined, from the beginning of the DPP regulatory period, because these will impact on the EDB's compliance and quality incentive outcomes. This will require adjustments to the quality incentive recoverable cost mechanism and the DPP compliance reporting requirements.

### Constant price revenue growth

27. There is no CPRG reopener proposed, because if the form of control is changed to a revenue cap (as proposed in the Form of control paper), it is no longer required. We support this decision. However, if the weighted average price cap is retained as the form of control, the ENA supports the introduction of a CPRG reopener for DPPs. This is because the CPRG assumptions can have a material impact on the ability of a supplier to recover its allowable revenues, and as documented by the Commission, this has proven difficult to forecast in practice.<sup>1</sup>

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<sup>1</sup>Refer Commerce Commission, Profitability of Electricity Distributors Following First Adjustments to Revenue Limits, Summary and analysis, 8 June 2016, page 17

## Workability

28. Since the IMs were first determined, there have been limited instances where an IM provision has become unworkable due to a change in circumstances, such as a specified dataset has ceased to be published. New reopeners are proposed to allow a DPP or CPP to be modified:
- By applying a next closest alternative approach; or
  - In response to a DPP requirement becoming unworkable and as a result a section 52Q amendment results in a non-equivalent effect on the price-quality path.
29. The ENA notes these proposals are likely to be required only in rare circumstances. For transparency purposes we submit that any such changes are consulted on before they are applied. We also question why the section 52Q reopener is required in practice.

## Major transactions

30. It is proposed that CPPs and DPPs are able to be reopened following a major transaction, if as a result of that transaction the price-quality path becomes unworkable. The ENA supports this proposal, which reflects the fact that there may be unforeseen consequences following a transaction which disrupt a DPP or CPP. We acknowledge it is not possible to fully anticipate these consequences when drafting DPP or CPP determinations. We support the requirement that any adjustment to the DPP or CPP is limited to mitigating the effect of the transaction.

## DPP/ CPP WACC alignment

31. Our response to the proposal to remove the CPP WACC and for CPP price paths to adopt the prevailing DPP WACC is included at the end of this section. We acknowledge the need for a CPP reopener to implement this proposal, as the DPP WACC for the entire CPP period is unlikely to be known at the time a CPP proposal is prepared.
32. It is proposed that when a new DPP WACC is determined during a CPP regulatory period the CPP price path will be reopened and adjusted from the date the new WACC comes into effect, by:
- Adjusting the CPP building blocks allowable revenue (BBAR) by substituting the DPP WACC in the cost of capital and timing factor calculations
  - Adjusting the CPP BBAR by substituting the revaluation rate with the forecast CPI included in the DPP WACC determination
  - Adjusting the forecast regulatory tax allowance in the BBAR after tax to reflect these adjustments
  - Retaining all other BBAR inputs which underpin the CPP price path
  - Adjusting the maximum allowable revenue (MAR) by substituting the DPP WACC in the present value calculations.
33. The ENA considers the proposed approach is reasonable, and should be relatively straight forward to implement as the changes will be made to explicit input assumptions in the CPP price path model which supports a CPP Determination.
34. We note however that the cost of debt assumptions used in the forecast regulatory tax allowance (including the regulatory tax adjustments used in the BBAR formula) are not to be updated to

reflect the cost of debt assumptions in the DPP WACC. We submit that they should be to ensure that the assumptions that underpin the CPP price path remain internally consistent, once the WACC changes.

### 4.3. Pass through and recoverable costs

#### Costs incurred prior to CPP approval

35. It is proposed that a new CPP recoverable cost allowance will be provided which recovers costs for an urgent project incurred between the time a CPP application is submitted, and the CPP comes into effect. This is contingent on approval of the cost in a CPP Determination. The cost incurred:
- Must be prudently incurred in responding to an urgent project.
  - Cannot already be provided for in a DPP or CPP determination.
  - Is not to be included in the value of a commissioned asset.
36. This proposal recognises potential costs to a supplier which are unable to be recovered through prices due to the prolonged CPP application and assessment process. The ENA therefore supports the proposal, with one variation. As capitalised costs associated with the urgent project are to be excluded, we submit the capex wash-up recoverable cost introduced for the recent EDB DPP Determination is extended to CPPs.
37. The purpose of the wash up is to adjust for the difference in forecast and actual commissioned assets in the period immediately prior to the new determination taking effect, recognising that the determinations are published prior to actual data becoming available. This ensures a price path is set based on the opening RAB at the beginning of the regulatory period. We consider this approach should be consistent for DPPs and CPPs, as the rationale for it is equally valid in both circumstances.<sup>2</sup>

#### Expanding the range of pass-through costs

38. It is proposed that additional pass through costs can be specified at the time a DPP or CPP is determined. Currently these can only be specified by amendment to an existing determination. We support this proposal which improves the workability of the original IMs.

#### Recovery of costs incurred in applying for a CPP

39. There are no changes proposed to the scope of the costs incurred in preparing a CPP which are able to be recovered through prices. This is contrary to the ENA's previous submissions on the topic which have suggested that as a CPP is an abnormal activity, which if approved, will be in the long term interests of consumers, then the most significant of the abnormal costs that are not provided for in existing price paths should be able to be recovered.
40. We are concerned at the comments in the CPP paper that the decision reflects a desire to ensure suppliers are incentivised to minimise the costs of preparing a CPP. The costs of preparing a CPP are directly related to the CPP IM requirements which the Commission

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<sup>2</sup> Commerce Commission, Input methodology amendments for electricity distribution services, Default price-quality paths, 27 November 2014, chapter 7

determines. The CPP IM process puts considerable obligations on the applicant in preparing the CPP (the costs of which are unable to be recovered through prices) in order to reduce the Commission's assessment requirements (the costs of which are able to be recovered through prices).

41. The ENA therefore retains its position that, it is in the long term interests of consumers for suppliers' abnormal costs incurred in preparing CPP applications to be recovered through prices, because the CPP determination is in the long term interests of consumers.

#### Fee payable to the engineer

42. The Draft Determinations include a new recoverable cost, relating to the fees payable to an engineer in respect of a DPP quality reopener application. We support this proposal, although as submitted above, we consider that the use of an engineer should be optional when seeking alternative quality standards under a DPP.

### 4.4. Aligning the CPP and DPP WACCs

43. As summarised in the Cost of capital paper, it is proposed that the CPP and DPP WACCs are aligned. This is to be implemented by removing CPP specific WACCs and adopting the prevailing DPP WACC for CPP price paths. However, because it is likely that CPP regulatory periods will extend from one DPP regulatory period into the next, the WACC to apply for the later part of a CPP may not be known at the time a CPP proposal is submitted and determined.
44. Accordingly it is proposed that the prevailing DPP WACC at the time the CPP is determined, is used in the CPP price path determination. In addition, the CPP price path is to be re-opened when a new DPP WACC comes into effect (refer to the commentary above regarding the CPP WACC reopener).
45. The ENA supports this proposal which is a simple solution to incentives for CPPs which may arise due to differences in DPP and CPP WACCs, and the additional benefit of removing the timing constraint currently imposed by the September CPP WACC determinations.
46. We also support the Commission's decision not to implement the dual WACC approach identified by Dr Lally.<sup>3</sup> We consider the proposed approach is a simple solution which is readily implemented, provides more certainty, and reduces cost and complexity of CPPs. Importantly it addresses the incentive problems that arise where the DPP and CPP WACCs differ. We note that this solution is independent of other WACC decisions such as how the cost of debt is determined to address volatility.
47. We agree with the Commission that the dual WACC approach would be administratively complex, and introduce additional uncertainty due to the additional and frequent variants of the CPP WACC that would be required. On balance we consider any potential benefits of a dual WACC approach would be outweighed by the costs, particularly as the alternative WACCs would only be applied to a small component of the regulatory asset base.

### 4.5. Recommendations

48. The ENA recommends that:

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<sup>3</sup> Refer Cost of capital paper, paragraphs 497-499.

- New CPP reopeners for contingent and unforeseen projects are adopted. In addition, if a revenue cap is introduced as the form of control we submit that a DPP reopener for unforeseen major connections is included
- The quality standard only CPP option is removed and is replaced by a quality only DPP reopener, to be made available within the current regulatory period, and to be initiated by suppliers. We consider the proposed reopener process can be improved in a number of ways, as discussed above
- If a weighted average price cap form of control is retained, a CPRG reopener is introduced
- New DPP and CPP reopeners for workability issues including a ‘next closest alternative’ solution are introduced as proposed, subject to some restrictions on when this can be applied and the Commission providing clarification of the proposed section 52Q reopener
- New DPP and CPP reopeners for unforeseen consequences of major transactions are introduced as proposed, subject to limiting any adjustments to the impact of the transaction on the price path or quality standards
- A new CPP reopener to accommodate the impact of a change in regulatory WACC which may occur during a CPP regulatory period is introduced as proposed. However the cost of debt assumptions used in the forecast regulatory tax allowance must also be updated to reflect the updated WACC
- A new urgent project recoverable cost is introduced for CPPs as proposed, contingent on extending the DPP capex wash-up recoverable cost allowance to CPPs. This will align the DPP and CPP price path methodologies, by ensuring a CPP price path appropriately reflects the opening RAB at the beginning of the regulatory period
- Pass-through costs for a forthcoming regulatory period may be specified as part of the determination as proposed
- The recoverable cost allowances for costs incurred in applying for a CPP are expanded to include prudent abnormal costs incurred by the applicant in making the CPP application, because incurring these costs is in the long term interests of consumers
- A new recoverable cost for engineering costs associated with a quality standard DPP reopener application is introduced as proposed, noting that the engineer’s report should be optional when applying for the DPP quality standard reopener.
- The proposal to apply DPP WACCs for CPPs is adopted because it addresses the incentive problem between DPPs and CPPs, removes a timing constraint in the CPP application process and is administratively simple to implement.

## 5. Evaluation of CPP proposals

### 5.1. Overview

49. The CPP paper:

- Explains how the Commission intends to assess CPP applications.
- Explains the 'proportionate scrutiny' principle.
- Proposes to retain the current CPP IM evaluation criteria.
- Includes additional clarification as to how the Commission intends to evaluate CPP proposals against the criteria.

### 5.2. Applying the proportionate scrutiny principle

50. It is proposed that in applying the proportionate scrutiny principle when assessing CPP applications, the Commission will:

- Generally aim for a level of cost and scrutiny that is commensurate with the materiality of the proposed change in prices or quality experienced by consumers, including consideration of the scale of the supplier.
- Establish a level of confidence in the supplier's own forecasts.
- Maintain a full set of upfront base information requirements.
- Apply modification and exemption provisions on a case by case basis.
- Maintain flexibility in transitioning at the end of a CPP.

51. The ENA supports these proposals in principle which will, if implemented, focus efforts on the drivers for the proposal, and the elements of the proposal which have the most impact on the outcomes which affect consumers. We suggest that the Commission demonstrates in its evaluation of a CPP application how its assessment is consistent with this principle. We consider there is a risk that despite best intentions, the proportionate scrutiny principle may be abandoned in favour of 'digging into the detail' in areas where it is not justified.

52. Further, we consider that there are more efficient ways to evaluate a proposal than requiring a full set of base information to be prepared, reviewed, audited and certified in advance. For example a workshop attended by the Commission, the verifier and the applicant's staff to test certain aspects of a proposed expenditure plan could be a more effective way to assess a proposal, than reviewing large volumes of documentation at arm's length.

53. We are therefore not persuaded that there is any strong justification for front loading the CPP application in the way that has been proposed. This imposes considerable cost on the applicant. We do not consider that the statutory timeframes available for assessing a CPP application is such a constraint, given the intention to apply the proportionate scrutiny principle, the verifier's role, the availability of the verifier to the Commission after the application has been submitted, and the ability to be innovative about how the assessment is undertaken.

## 5.3. Assessing CPP proposals

### IM requirements

54. The CPP paper includes a discussion of how the Commission expects to assess CPP proposals. The paper explains that the approach is not set out in the IMs, but the IM requirements support the approach.
55. The ENA is concerned about this suggestion because it introduces unnecessary uncertainty into the CPP process and additional cost and complexity. A supplier must prepare a CPP application in accordance with the IMs. The IMs set out the information which must be included in the application, pre application processes which the applicant must follow, and the evaluation criteria which the Commission must apply when assessing the proposal.
56. The informal introduction of additional processes and criteria in consultation and decision papers is extremely unhelpful. CPP applicants have a statutory obligation to prepare a CPP application which is consistent with the IMs. There is no such obligation to prepare a CPP application in accordance with other requirements, and the status of the additional requirements included in supporting papers is unclear.
57. We submit that any assessment of a CPP proposal must be consistent with and not extend beyond the criteria included in the IMs. As highlighted elsewhere in this submission, the proposed amendments to the CPP IMs and Schedules introduce evaluation criteria which are not consistent with the IMs and they must be removed from the drafting. In addition we submit that any explanation of the Commission's approach to assessing a CPP must be tied into the IMs, by way of interpretation of the evaluation criteria. This is currently lacking in the CPP paper.

### Assessment of expenditure

58. The CPP paper explains the Commission's approach to assessing CPP expenditure as follows:
  - Top down review of a supplier's policies, strategies and processes.
  - Supported by a bottom up review of selected projects and programmes.
  - Review of input assumptions and source data used for forecasting expenditure.
  - Pre-application verification of expenditure to, amongst other things, review selected projects and programmes, provide feedback to suppliers and highlight areas for the Commission's assessment.
  - Limited bottom-up review of areas highlighted by the verifier to complement rather than repeat the verifier's assessment.
  - Review the models used to prepare the forecasts and consider if the models, outputs and conclusions from the models are reasonable.
59. We understand the proposed process and make the following comments:
  - As previously submitted, we consider this assessment process could be improved by retaining the verifier for the assessment phase and leveraging the knowledge and insights already gained to minimise the re-learning required by the Commission and/or its advisors.

- We question whether the process described above is in fact a top down assessment supported by limited bottom up review. The final bullet point above (extracted from paragraph 175 of the CPP paper) implies it may not be in practice.

### Evaluation of price path information

60. As stated in the CPP paper, the evaluation of the price path is largely determined by the building blocks, which are specified in the IMs, and any price path smoothing or variations to the IMs which may be proposed. We agree with these observations, and note that the price path model will be a key component of this assessment.

### Evaluation of quality standard variation information

61. The CPP paper sets out areas of likely focus for the Commission when assessing a quality standard variation proposal. We note that an initial assessment is to be included in the verifier's TOR.
62. The proposed evaluation however goes beyond the criteria and the relevant information requirements specified in the IMs. This needs to be addressed, otherwise the information in the CPP proposal will not align with how the Commission intends to form a view on the quality standards. For example the IMs do not refer to:
- Historical reasons for deterioration in drivers of reliability
  - Prudence of historical decisions to manage deterioration.
63. In addition, we note that the CPP is forward looking and the IM evaluation criteria reflect this by focussing on the realistically achievable performance of the EDB over the CPP regulatory period.

### Information requirements

64. The CPP paper describes the Commission's expectations for information to be included in a CPP proposal, as follows:
- The proposal must be fit for purpose including:
    - appropriate scope and specificity
    - is able to be relied upon – which is assisted by the pre application verification and audit processes
    - evidence of how services required by consumers have been determined – which is assisted by the consumer consultation requirements.
  - Provide prescribed base information.
  - Exemption and modifications may be permitted, including accounting for supplier scale.
  - Flexibility in how more detailed information is provided.
65. The paper acknowledges the increased burden a CPP is likely to place on smaller suppliers as many of the application costs are unlikely to reduce significantly for a smaller supplier. The proposed solution is to consider scale explicitly when assessing applications for modifications and exemptions. We note that there is also a cost in applying for exemptions and modifications.

66. While this may assist in some manner, the ENA remains concerned that the costs and complexity inherent in the CPP process mean that in practice the costs are likely to outweigh the benefits for smaller suppliers. Accordingly smaller suppliers are unlikely to apply for a CPP, even when it may be in the long term interests of consumers. This further supports our submission that the abnormal and prudent costs incurred by a supplier in making a CPP application should be able to be recovered through prices.

## 5.4. Recommendations

67. The ENA recommends that:

- The proportionate scrutiny principle is applied in assessing CPP proposals, and the Commission demonstrates in its decisions how its assessment is consistent with this principle
- The Commission considers alternative assessment approaches to improve effectiveness including retaining the verifier after a CPP application has been submitted and workshops with the applicant. These approaches can further decrease the cost and complexity of CPPs by reducing the upfront burden on applicants to produce significant volumes of written material for a CPP application.
- All guidance and explanation about how the Commission will assess a CPP proposal is directly linked to the IM requirements. Additional and informal information requirements and assessment criteria introduced in consultation or decision papers only add to the complexity and uncertainty of the CPP process
- Supplier scale is explicitly considered when assessing applications for modifications and exemptions to the CPP requirements
- The abnormal and prudent costs of preparing a CPP proposal are recovered through prices, to enable smaller suppliers to apply for a CPP when it is in the long terms interests of their consumers.

# 6. Information requirements

## 6.1. Overview

68. The CPP paper proposes to reduce cost and complexity of CPP applications by:

- Leveraging from existing ID disclosures.
- Removing duplicate and superfluous information requirements.
- Reducing the level of disaggregated information.
- Including new requirements for deliverability information.
- Including new requirements for real and nominal forecast expenditure information.
- Clarifying that information in financial spreadsheets forms part of the proposal.

69. These changes form a significant component of the proposed amendments to the CPP IMs, in particular Schedules D and E. Our detailed comments on the drafting are included in our submission on the Draft Determinations. In this submission we highlight the proposed changes which we support, and the areas where we consider further changes are required to reduce cost and complexity, and address ambiguities, omissions and errors in the proposed draft amendments.

## 6.2. Misalignment of qualitative information for CPPs and ID

### AMP-plus approach

70. The ENA supports the proposal to more closely align the qualitative information requirements for CPPs with the Asset Management Plan (AMP) requirements as specified for ID purposes. This will reduce cost and complexity, and recognises that EDB AMPs are mature documents which cover many of the topics which are relevant to a CPP, particularly forecasts of demand, service outcomes, capex and opex.
71. We recognise that additional information may be required to support a CPP proposal. However, starting with the AMP and specifying the incremental information requirements will make a CPP significantly less complex for suppliers. In addition, it has the advantage of replicating in the CPP the planning processes already in place for a supplier.

### Scope of Schedule D

72. The revised draft of Schedule D largely incorporates suggestions the ENA made following the CPP workshop in late April, and incorporates direct links to Attachment A of the ID determination and relevant definitions from ID. We support this proposed approach to Schedule D.
73. The CPP paper raises concerns that there will be a need to update the CPP IMs when the ID changes; there may be additional uncertainty for a CPP applicant when ID is reviewed; and the CPP completeness assessment may not be mechanistic. We consider these concerns are overstated, because there are already considerable linkages between the ID and CPP requirements which need to be maintained including in Schedule B, C and E templates and data and methods which underpin BBAR.

### Aligning Schedules B and C

74. There is no proposal to align Schedules B and C with ID. It appears that this has not been considered as part of the review, which is a material oversight that should be addressed. The ENA submits that Schedules B and C should be updated to reflect the ID cost allocation schedules, consistent with the approach to be adopted for Schedule E. This would improve alignment of the two sets of disclosures and therefore reduce cost and complexity. It would also better reflect the CPP cost allocation IM which requires applicants to roll forward into the CPP price path the cost allocation method applied in the most recent disclosure year.

## 6.3. Deliverability at an aggregate level

75. The ENA supports the proposal to require a CPP applicant to demonstrate the deliverability of the CPP expenditure forecast, at an aggregate level. However the ENA does not support the

suggestion that the applicant will prepare a single deliverability report. This is not necessary, is inconsistent with the AMP-plus approach, and the structure of the CPP IMs.

## 6.4. Duplication of price path information

76. It is proposed to clarify that information included in spreadsheets which support the CPP price path form part of the CPP proposal. The ENA supports this proposal which reduces cost and complexity.
77. The CPP paper provides clarifications as to how this information is to be presented in spreadsheets. The ENA submits that these requirements should be included in the IMs to minimise complexity and improve certainty – they can be inserted in Clause 5.4.7.

## 6.5. Unnecessary disaggregation of quantitative information

78. It is proposed that the level of disaggregation of forecast information in a CPP proposal is reduced, to reduce compliance cost. The ENA supports this proposal because more aggregated information is consistent with the forecast nature of a CPP. More detail does not necessarily translate into more accurate forecasts. In particular we support:
  - Removal of the requirement to allocate expenditure and projects and programmes into service categories.
  - Removal of the requirement to allocate project and programme capex into asset sub-categories (as per Schedule A of the existing IMs), to be replaced with asset sub-categories at an aggregate level.
  - Removal of controllable and uncontrollable opex categories – due to a change in the Incremental Rolling Incentive Scheme (**IRIS**) IMs.
  - Removal of the requirement to forecast related party transaction information on a project basis.

### Aggregating capex forecasts

79. In this respect we note that the capex categories to be used for CPP information purposes are to align with the ID categories, including those used in AMPs. This alignment will assist in managing compliance cost. Suppliers are able to apply for modifications if they prefer alternative categories which better match their own planning processes. In addition it is proposed that capital contributions are able to be forecast at an aggregate level by expenditure category.
80. However this proposal has only been included in the information requirements section of the CPP IMs. For it to have any real impact it must be translated through into the price path section of the IMs, in particular the methodology for forecasting the regulatory asset base (**RAB**) and the regulatory tax asset value. Modified RAB and tax depreciation methods are required to accommodate this change in capex and capital contribution categorisation. Otherwise more detailed capex allocations will be required for the price path calculations which will compromise the reduced cost and complexity objective of the change.

81. In addition, it is necessary to specify when the aggregated approach first applies for a CPP proposal, including the BBAR calculations. Is it at the beginning of the assessment period, or the CPP regulatory period?

### Related party transactions

82. The ENA supports the proposal to reduce the amount of information required in a CPP proposal about related party transactions, and to recognise that it will not be possible to determine with certainty to what extent future transactions may or may not be undertaken with related parties.
83. However the proposed amendments to Schedule D do not give effect to this objective in practice. They also do not adequately consider the implications of providing the prescribed information for a 10 to 12 year period (ie: the 5 year current period, 2 year assessment period and 3-5 year regulatory period).
84. Accordingly, the information requirements are still too onerous, and we submit unnecessarily so. A better approach would be for the applicant to:
- Describe the related party relationships and services provided by those parties during the last year of the current period – which could be by reference to ID disclosures.
  - Describe the processes for procuring the services undertaken by related parties and prospective related parties in the assessment period, and provide documentation which illustrates these processes (on a sample basis).
  - Describe the basis for valuation of related party transactions for the services identified above, in accordance with the IMs.
  - Identify any ongoing contracts which extend into the regulatory period for services provided by related parties.
85. A reasonable application of the proportionate scrutiny principle is to sample supporting evidence for related party transactions. This is because there may be numerous transactions for discrete projects or programmes across the relevant periods. Currently Schedule D includes terms such as *'all relevant documents to tender for the provision of the services..'* which conflicts with the objective to assess related party transactions at an aggregate level.

## 6.6. Insufficient flexibility in providing information

86. We welcome measures to increase flexibility in meeting CPP information requirements, in particular:
- To allow applicants to use exemptions or modified approaches, following approval by the Commission.
  - To encourage applicants to focus on the actual processes used to forecast expenditure and service outcomes – and provide evidence in support of those processes, rather than on the processes that might be implied by the IMs.

87. In this respect, the ENA submits that the unit cost and expenditure escalator information requirements in Schedule D and E are too prescriptive. They do not recognise that EDBs may use a range of different methods for forecasting the input cost components of capex and opex plans. The current IMs only reflect one of those possible methods. We suggest that Schedule D and Schedule E are modified to require applicants to:

- Describe the methods employed for estimating the labour and materials costs inherent in the capex and opex programme.
- Explain the forecasting methods with reference to historical labour and materials costs where relevant.
- Specify the key assumptions used in these forecasts, including source data, unit rates, weightings, escalators and contingency factors where relevant.
- Quantify the impact of the key assumptions on the real and nominal expenditure forecasts.

## 6.7. Recommendations

88. The ENA recommends that:

- The CPP information requirements are modified to reduce cost and complexity including better alignment with ID information.
- An AMP-plus approach is adopted as proposed.
- CPP applicants are required to consider the deliverability of the proposed expenditure plan, at an aggregate level, but are not required to produce a 'deliverability report'.
- The proposal to clarify that price path models form part of the CPP proposal is further developed, by including the Commission's expectations about the information in the models in the CPP IMs at clause 5.4.7.
- Unnecessary disaggregation of quantitative information is removed from the CPP information requirements, however:
  - the proposed capex and capital contribution information changes must be carried through into the asset valuation and regulatory tax building blocks methods in order for them to have any real impact on CPP compliance complexity
  - the proposals can be further improved for related party transaction information.
- Schedules B and C are updated to reflect the ID cost allocation schedules.
- Measures to increase flexibility in meeting CPP information requirements are introduced, including redrafting the information requirements for unit cost and expenditure escalators to recognise that EDBs may apply a range of different approaches when preparing their expenditure forecasts.

## 7. Verification requirements

### 7.1. Overview

89. The CPP paper proposes to clarify the verifier's role and simplify the engagement between the verifier, suppliers and the Commission. In particular it is proposed that:
- The verifier's TOR defines the verifier's role, purpose and obligations.
  - The verifier no longer assesses non-standard depreciation.
  - The applicant provides a high level summary of the application to the Commission.
  - A communication protocol is included in the verifier's tripartite deed.
  - More flexibility is provided to the verifier in selecting projects and programmes for detailed review.
  - The independent engineer's assessment of a quality standard variation is transferred to the verifier.
  - The verifier reviews the extent and effectiveness of the supplier's consultation with consumers.

### 7.2. Purpose and role

90. The verifier assists the Commission to assess a CPP application by reviewing certain aspects of the draft CPP proposal and highlighting areas for potential focus. The verifier also assists the applicant by commenting on aspects of a CPP proposal which the applicant is able to consider before submitting its application. Both of these roles are important, and are reflected in the tripartite agreement arrangements.
91. In refining the scope of the verifier, as set out in Schedule G of the IMs, both of these objectives should be recognised. However, the ENA submits that section G2 does not accurately reflect the intended role of the verifier because it is too broad and it introduces evaluation criteria which are not consistent with the IMs, in particular the expenditure objective. Our submission on the Draft Determinations includes suggested improvements to address these points.

### 7.3. Summary report

92. The Commission wishes a CPP applicant to provide it with a high level proposal summary at the time the verifier is engaged. This is to help the Commission with its preliminary resource planning. The requirement is included in Schedule F which sets out the requirements for engaging a verifier.
93. The ENA does not consider this report is justified and it will add undue cost and complexity to the CPP process. The proposed summary duplicates the verifier's role which recommends the areas of focus for the Commission. It is also to be prepared too early in the development stage of a CPP proposal. It must be refined and resubmitted at a later stage, which means the applicant must explain it well before the CPP proposal is submitted. Thus it introduces Commission

scrutiny into the CPP development phase. It is also likely to be distracting at a time when the applicant is most resource constrained.

94. Accordingly the ENA does not support this proposal. The Commission is able to discuss a forthcoming proposal with an applicant once the verifier has been engaged. The Commission also has access to substantial forecast information about the applicant prior to a CPP proposal being submitted through information disclosure and CPP consultation processes.

## 7.4. Communication

95. The ENA supports the proposal to clarify the communication protocols for the verifier. In particular we note:
- The deed protects the interests of all parties, and as such the Commission need have no direct involvement in the verification review prior to the CPP application being submitted.
  - The verifier should keep a record of the important information which supports its findings, but should not be required to submit with its report all of the evidence it reviewed - as this would duplicate the CPP proposal itself, and has the potential to extend well beyond the IM information requirements.

## 7.5. Identified projects and programmes

96. As stated previously we support more flexibility in how the verifier selects the projects and programmes for detailed review. This includes flexibility in the number of projects, up to a specified maximum number, with appropriate guidance on how the projects may be selected. However, we submit that the draft guidance in Schedule G can be improved to remove duplication and better align it with the rest of the IMs, in particular the reasons for the CPP proposal, the CPP evaluation criteria, and the proportionate scrutiny principle.

## 7.6. Independent engineer

97. It is proposed that the role of the independent engineer in reviewing the quality standard variation is transferred to the verifier. The ENA supports this proposal because of the link between forecast quality outcomes and expenditure. We submit that Schedule G does not adequately recognise this extended role and can be improved in this respect.

## 7.7. Non-standard depreciation and cost allocation

98. The ENA supports the proposal to remove the requirement to review non-standard depreciation from the verifier's TOR. We do not however support the proposal for the verifier to review the application of the cost allocation method.
99. These are not areas where the verifier would naturally have the appropriate expertise. Importantly, as the cost allocation methodology for CPPs is required to be the same method as applied by the EDB in the most recent disclosure year, the most effective review will be that undertaken by the auditor. This is because the auditor will have audited the prior year disclosures (including cost and asset allocation methods and calculations) and will audit the forecast CPP expenditure (including the Schedule E expenditure templates), and therefore will be

able to assess the consistency or otherwise of the methods employed. This is already in the scope of the audit.

100. We note that the CPP paper suggests that the cost allocation review will involve capitalisation of overheads and related party costs and this is why it is included in the verifier's TOR. We challenge this understanding. Cost allocation ring fences the costs and assets of regulated services from non-regulated services. Capitalisation rules and the valuation of related party transactions determine the value of regulated service transactions. Assessment of the latter, does not require assessment of the former.

## 7.8. Consultation

101. We support the extension to the verifier's scope of work to include an assessment of the extent and effectiveness of the supplier's consultation, and comment further on this below. However we consider that the verifier should focus primarily on the effectiveness of the consultation material and the ways in which the applicant engaged with its consumers. We do not consider the verifier should or could be expected to comment on the CPP proposal represented in the consultation such as price-quality-trade-offs proposed by the applicant.

## 7.9. Recommendations

102. The ENA recommends that:

- The verifier's TOR is amended to define the verifier's role, purpose and obligations, but the proposed amendment is further improved to remove ambiguity and better align with the remainder of the CPP IMs.
- The verifier no longer assesses non-standard depreciation, and in addition does not assess cost allocation.
- The proposal for the applicant to provide a high level summary of the application to the Commission is removed, as it adds undue cost and complexity and it opens the applicant to Commission scrutiny too early. Further the Commission has access to other information to help it plan and focus its assessment of a CPP proposal.
- A communication protocol is included in the verifier's tripartite deed.
- There is more flexibility for the verifier in selecting projects and programmes for detailed review, but the associated draft guidance is improved.
- An independent engineer no longer assesses a quality standard variation, to be included instead in the verifier's TOR, with more specificity than in the current draft.
- The verifier's review of the extent and effectiveness of the supplier's consultation with consumers does not include forming a view on the proposed price path or the trade-off between price and quality of service.

# 8. Audit requirements

## 8.1. Overview

103. The CPP paper proposes that the pre application audit requirements are refined to:

- Clarify the auditor must expressly provide an audit report on the CPP proposal.
- Clarify the audit standards to be applied.
- Align the scope of the audit with the information requirements.

## 8.2. Clarifying assurance requirements

104. The ENA supports the proposal to clarify the assurance requirements for CPP applications, and in particular to recognise that different assurance procedures are relevant for historical and forecast information.
105. The ENA suggests that the proposed amendments can be further improved to increase certainty for auditors, and to better enable them to fulfil their obligations. This in turn will assist Directors when they certify the CPP application, and the Commission in assessing the application. Our submission on the Draft Determination includes our suggested amendments.

## 8.3. Recommendations

106. The ENA recommends that the audit requirements are further amended to provide more clarity over the role of the auditor and the form of audit report to be issued.

# 9. Consumer consultation requirements

## 9.1. Overview

107. The CPP paper proposes that the consumer consultation requirements are refined to clarify that price/quality trade-offs should be consulted on, including presentation of alternative investment options. In addition it is proposed that the verifier will report on the extent and effectiveness of the consultation. We support these proposals.

## 9.2. Expectations for consumer consultation

108. The ENA supports further clarity on the expectations for consultation with consumers on CPP proposals. This should avoid the need for the Commission to undertake its own consumer consultation on a CPP, recognising the Commission consults more broadly with stakeholders when making a CPP determination.
109. We also note that the change in the CPP WACC method does partly alleviate a constraint in the consultation timetable. However the consultation on the CPP proposal itself (as opposed to consumer consultation more generally) will necessarily occur reasonably late in the pre application process because it is reliant on the applicant having a well-developed proposal before consultation can commence.
110. We support the intent for applicants to determine how best to consult with consumers. We note that the Commission expects applicants will consult with consumers about price/quality trade-offs by identifying any investment alternatives. The ENA suggests that the investment alternative expectation is too broad given the diverse nature of distribution networks which comprise multiple asset components. Accordingly we submit that the consultation on investment alternatives

should focus on the main reasons for the CPP proposal. This requirement would then link directly into the CPP proposal information to be assessed by the Commission – refer IM Clause 5.4.2.

### 9.3. Recommendations

111. The ENA recommends that:

- The IMs further clarify the expectations for consumer consultation on a CPP proposal.
- CPP applicants are able to determine how best to consult with their own consumers.
- 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 CPP proposal.

## 10. Appendix

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

Alpine Energy  
Aurora Energy  
Buller Electricity  
Counties Power  
Eastland Network  
Electra  
EA Networks  
Horizon Energy Distribution  
Mainpower NZ  
Marlborough Lines  
Nelson Electricity  
Network Tasman  
Network Waitaki  
Northpower  
Orion New Zealand  
Powerco  
PowerNet  
Scanpower  
The Lines Company  
Top Energy  
Unison Networks  
Vector  
Waipa Networks  
WEL Networks  
Wellington Electricity Lines  
Westpower