



MAJOR ELECTRICITY USERS' GROUP

29 November 2006

Unison Post-Breach Inquiry
Network Performance Group, Networks Branch
Commerce Commission
By email to electricity@comcom.govt.nz

Dear Commission

Submission on Unison's draft settlement proposal

1. This is a submission by the Major Electricity Users' Group (MEUG) on the draft settlement proposed by Unison dated 1 September and the Commerce Commission draft decision recommending acceptance of that proposal dated 9 November 2006.

Background

2. Unison has breached both the price and parts of the quality threshold for every assessment date since the Commission first set thresholds in June 2003. At the same time Unison has been earning excess returns.
3. Unison has calculated the proposed settlement on the basis of a target return on investment of 4.6% in real terms. The Commission has estimated this is equivalent to a target post-tax nominal WACC of 9.1%¹. This is significantly greater than the current mid point WACC estimate by the Commission of 7.35%. MEUG notes the Unison target WACC of 9.1% also exceeds the upper range estimated by the Commission of 8.45%. The Commission provides no explanation why a target WACC in excess of the mid point as well as the upper band should be acceptable². The table below summarise actual to date and forecast excess returns:

| Year ending 31 March | Unison actual ROI ³ | Unison target WACC | Commerce Commission mid point WACC ⁴ | Unison excess return | |
|-------------------------|-----------------------------------|-----------------------|---|-------------------------|--------|
| 2003 | 17.74% | | | | |
| 2004 | 33.41% | | 6.80% | +26.61% | Actual |
| 2005 | 10.67% | | 6.95% | +3.72% | Actual |
| 2006 | To be published | | 7.35% | | |
| 2007 | | 9.10% | 7.35% | +1.75% | F/cast |
| 2008 | | 9.10% | 7.35% | +1.75% | F/cast |
| 2009 | | 9.10% | 7.35% | +1.75% | F/cast |

¹ Commerce Commission, *Draft decision: Reasons for not declaring control – Unison Networks Limited*, 9 November 2006, footnote 67, p 48

² The WACC range estimated by the Commission is 6.45% to 8.45% with a mid point of 7.35%

³ NZ Gazette, No. 143, *Unison Networks Limited, Information for disclosure pursuant to s.57T of the Commerce Act 1986*, 26 August 2005, p 3505. These actual ROI include revaluations as required by the Disclosure Requirements.

⁴ Commerce Commission, *Intention to Declare Control – Unison Networks Limited*, 9 September 2005, p 8 and p9

4. Assuming a regulatory asset base for Unison of \$285 million⁵, then every 1% excess return (post tax basis) equals an overpayment by consumers for line charges of \$4.25 million per annum (ie grossed up for tax). The excess charges to date and forecast excess returns are therefore not trivial amounts.
5. MEUG acknowledge control is not a trivial step either. However, the Commission's estimated⁶ direct costs of control of \$614,000 per annum appear to be significantly less than the benefit that would accrue to consumers by mitigating Unison's stated intention, as set out in the settlement offer, to continue charging prices inclusive of material excess returns.

Detailed comments

6. Referring to the Unison settlement offer dated 1 September 2006:
 - a) Instantaneous reserve (IR) income is not included as a line business income (p 8). MEUG note that this may be an issue and the question of who "owns" the right to make load available for IR and therefore who benefits should be addressed, i.e. is it the line business, retailers or end consumers?
 - b) Unison state (p16):

"Unison does not intend to invest to specifically to bring quality within the quality threshold levels because it is doubtful that these levels reflect the previous quality experienced by consumers and to target these levels of performance is likely to result in inefficient expenditure and would be inconsistent with consumers' expressed preference not to pay more for better quality."

MEUG has two comments:

 - If Unison is not investing to achieve the quality levels of the thresholds, then what target quality is it seeking?

A settlement where a key outcome such as the target level of quality is not agreed isn't a sound basis for any sort of agreement. If Unison don't accept the obligation to try and achieve the quality thresholds then the settlement offer is unacceptable.

 - Unison should be required to disclose the evidence of consumer preferences regarding quality to enable an understanding of what choices between quality and line charges Unison offered to various voltage classes of consumer and the responses Unison received.
 - c) Undergrounding of overhead assets (OHUG) in Napier and Hastings is budgeted at \$1.5m per annum for 2006/07 through to 2008/09 (p 19). The driver for this work is "consumer amenity value" (appendix B, paragraph 8.1). It's unclear if this work is covered by a grant from the Hawke's Bay Power Consumers' Trust using dividends received from Unison. If not, then it should be, just as the Rotorua Energy Charitable Trust contributes to OHUG in Rotorua. This point is also made by PB Associates in their report to the Commission (refer p 19 of the PB Associates report).
 - d) The cost of supply model in the settlement proposal groups consumers into 5 classes: un-metered, mass market, small commercial, large commercial and industrial (refer ICP numbers per class in table A.15, p30). There is insufficient description of those classes for a potentially affected consumer to establish, for example, if they fall within the small commercial or large commercial classes. The impact of the settlement between these two classes is very material (refer table A.39, p46), e.g. a small commercial consumer in Rotorua/Taupo will have an increase in

⁵ NZ Gazette, No. 143, *Unison Networks Limited, Information for disclosure pursuant to s.57T of the Commerce Act 1986*, 26 August 2005, p 3508

⁶ Commerce Commission, *Intention to Declare Control – Unison Networks Limited*, 9 September 2005, p67

unit charges whereas large consumers have a large decrease. MEUG suggest Unison provide more details to allow individual consumers to determine which class within the cost of supply model applies to them.

- e) The settlement proposal makes no mention of how any bi-lateral contracts are managed. MEUG suggest that the details of cash flows and which assets are ring-fenced for such bi-lateral contracts need to be disclosed if material. Bi-lateral contracts may also cover provision of IR (refer comment in paragraph 6 a) above).
- f) A uniform real rate of return of 4.6% is assumed for the cost model (refer table A.37.3, p45). MEUG has two concerns:
 - i) The 4.6% (real) is estimated to be equivalent to 9.1% post-tax nominal WACC. Why this should be acceptable to consumers when the Commission mid point estimate is 7.35% and the Commission upper range value of 8.45% is even lower than Unison's target needs an explanation. This point was made in paragraph 3 above also.
 - ii) It's not clear that every consumer class has identical risk to justify a uniform real rate of return. Large time-of-use consumers will tend to have dedicated assets covered by bi-lateral contracts and their share of high voltage assets covered by line tariffs with a large fixed component. By comparison non time-of-use consumer classes tend to have a higher proportion of variable charges giving more uncertainty in year by year revenues to Unison than large consumers.
- g) The Unison regulatory asset base assumed for the cost allocation model as at 31 March 2006 is \$357.7m (refer table A.37.3, p45). This appears to be overstated compared to the audited ODV published pursuant to the Electricity Information Disclosure Requirements as at 31 March 2005 of \$285.7m even allowing for inflation over one year and new investment. Unison should be requested to reconcile in detail the large difference in asset value assumed relative to the regulatory asset base. Part of the answer is no doubt the extension of asset lives assumed noted in appendix B1. But we shouldn't have to guess at the components of the reconciliation as Unison should have made that explicit.

MEUG note:

- Some scepticism on the recent discovery that assets actually have much longer life times, ie the advice of Wilson Cook & Co (Appendix B1) is dated 9 May 2006, some years after Unison increased charges;
- Concern that Unison has decided to use a different asset value for the cost allocation model rather than use the Disclosure Requirements ODV. The latter is superior from a consumer viewpoint because it has been based on a methodology that has been extensively consulted on and subject to audit requirements set out in regulation. MEUG note that a benefit of standardising valuation methodologies and using the output in standard cost allocation models is that consumers anywhere in New Zealand will be able to benchmark their line charge with that of similar consumers. Unison's alternative valuation approach appears to undermine that policy objective.
- Unison should be asked to explain why on the one hand some of the asset base is actually in better shape than they previously thought and hence asset lives can be extended, yet on the other hand the assets are in such poor shape that a significant increase in renewals capital expenditure and operating and maintenance is required.
- If the Disclosure Requirements ODV were used for the cost allocation model, then prices for all classes of consumers in all regions would decrease relative to the settlement proposal by Unison.

7. Referring to the PB Associates report prepared for the Commission:

a) On page 14 PB Associates state:

"We would have liked to see the maintenance budget disaggregated further since this would have provided a higher level of transparency as to the impact of different maintenance activities. Such a breakdown could have shown, for example, that a significant proportion of the operation and maintenance expenditure budget is dedicated to vegetation control, which may over time result in a significant improvement in Unison's reliability indicators."

MEUG agree that Unison should be required to provide more disaggregated detail of their actual to date and forecast operating and maintenance budget.

b) On page 15 PB Associates note that the LeverEdge model used by Unison for determining the asset renewal costs is sensitive, amongst other things, to the discount rate assumed. Unison assumes 5.8% real. PB Associates note they have not assessed the validity of that assumption. MEUG suggest the Commission needs to reconcile the discount rate used in the LeverEdge model with the 4.6% rate used in the Unison cost allocation model and the Commission's mid point target WACC of 7.35%. Having different discount rates without any reconciliation between them creates uncertainty about the robustness of the Unison approach.

c) On page 15 PB Associates state:

"We note that there is no comparison between the budgeted asset renewal expenditure in the 2005 AMP and that in the 2006 plan, and as a result there is no explanation for the significant increase in the forecast. Indeed, when compared with the 2005 plan, the 2006 plan includes targets indicating lower network reliability despite a higher asset renewal budget. As this planning is counter-intuitive, in that a higher budget would normally be expected to deliver improved network reliability, a stakeholder comparing the two plans, without further explanation, would be confused as what is happening."

MEUG suggest the Commission requires Unison to explain the above change identified by PB Associates. As an example PB Associates (p15) note the LeverEdge model relied upon by Unison probably forecasts an upper bound for renewal expenditure and,

"..., we believe that there is scope to reduce the asset renewal budget below the level proposed by LeverEdge without significantly impacting the level of supply reliability."

d) On page 17 PB Associates state:

"We consider that significantly more detailed breakdowns of the augmentation and asset renewals asset categories should have been provided. Both of these budgets were developed from a top down analysis to form a basis for an Administrative Settlement Proposal. While this is appropriate, we believe the AMP should have included a bottom up analysis that allocated this expenditure in more detail."

MEUG do not agree with the belief of PB Associates that the top down high level capital expenditure budget rather than a detailed bottom up budget is necessary for an Administrative Settlement. The Commission and consumers need certainty that the proposed settlement terms and conditions are robust. This needs to be taken in light of a company that has consistently breached the price thresholds each year and arguably delayed the intention to control process by court action and delayed tabling of settlement offers. The company should be required to provide the details of the augmentation and asset renewal forecasts that PB Associates believe should already have been provided in the AMP.

8. MEUG has three further comments on the Commission's paper of 9 November 2006:

- a) The assessment and quantification of costs, benefits and net benefits of accepting the proposed settlement compared to the counterfactual of control was well set out and tabulated by the Commission in the report, *Intention to Declare Control – Unison Networks Limited*, 9 September 2005. However, in the Commission paper of 9 November 2006 understanding what the relative values of the benefits and costs of the Unison proposed settlement compared to the counterfactual of control requires readers to interpret from:
- i) A graph titled "Figure 2: Distribution Charge Revenue Projections in the Intention Paper," (paragraph 195, p55);
 - ii) The discussion in the text (p55 to p59); and
 - iii) Some understanding of the various scenarios in the prior Commission report of 9 September 2005 report.

This would be very challenging for most readers. MEUG suggest the final decision by the Commission must assess and quantify costs and benefits to the standard set by their 9 September 2005 report.

- b) The Commission should consider if there is a precedent risk of the factual (accepting the Unison settlement offer) relative to the counterfactual of control. The risk is that distributors (including Unison itself) will perceive the acceptance of the Unison settlement as an indication that there will be very little risk of a material regulatory response if for the last one or two years of the current 5 year threshold regime they deliberately increase line charges above the threshold regime level.
- c) On page 8 the Commission requests comments on Unison's Cost of Supply model. MEUG has previously made comments and participated in the Electricity Commission process to develop a Cost of Supply model and understand the Unison model is based on that work. Overall the principles being developed by the Electricity Commission for a model distribution cost allocation model was making good progress. That work has yet to be completed. However, MEUG has concerns with the application of the model principles by Unison. The following examples of our concern have already been mentioned in this submission (with paragraph cross-references in brackets):
- i) Details of material bi-lateral contracts not disclosed (paragraph 6 e));
 - ii) Why should the effective WACC be 9.1% rather than 7.35% (paragraph 6 f i));
 - iii) Why should all consumer classes have the same rate of return? (paragraph 6 f ii)); and
 - iv) The asset base should be reconciled in detail back to the Disclosure Requirements ODV (paragraph 7 g)).
9. Ideally MEUG would like replies to the various information requested as part of this submission to allow a more informed cross-submission. MEUG recommends the Commission seek this information urgently from Unison. MEUG will also be relying upon information disclosed by Unison for the year ended 31 March 2006 (required to be released by the end of November pursuant to s.57T of the Commerce Act 1986.) We trust there will be no delays in this information being made public.

Yours sincerely



Ralph Matthes
Executive Director