MAJOR ELECTRICITY USERS' GROUP

11 December 2006

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

Dear Commission

Cross-submission on Unison's draft settlement proposal

1. This cross-submission by the Major Electricity Users' Group (MEUG) on the draft settlement proposed by Unison supplements the initial MEUG submission of 29 November. That earlier submission recommended Unison and the Commission furnish a number of detailed pieces of information and explanations. That information is not available to make a cross-submission on. Therefore this cross-submission only considers some aspects of the submissions of other parties plus new evidence from Unison's Gazette disclosures pursuant to the Disclosure Requirements.

Further details on excess charging

2. The table below is the same as the initial MEUG submission except for the addition of data for the year ended 31 March 2006 that has just been published in the Gazette (refer bold red text in the table).

Year ending 31 March	Unison actual ROI[1]	Unison target WACC	CC mid point WACC[2]	Unison excess return	
2003	17.74%				
2004	33.41%		6.80%	+26.61%	Actual
2005	10.67%		6.95%	+3.72%	Actual
2006	**10.39%**		**7.35%**	**+3.05%**	**Actual**
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

3. The new data for 2006 confirms Unison has materially exceeded the WACC an efficient line business could expect to earn over the period it breached the price threshold. For instance in 2006 the excess return was 41% over the Commerce Commission mid point WACC[3].

[1] NZ Gazette, No. 157, *Unison Networks Limited, Information for disclosure pursuant to s.57T of the Commerce Act 1986*, 29 November 2006, p 4592
[2] Commerce Commission, *Intention to Declare Control – Unison Networks Limited*, 9 September 2005, p 8 and p9
[3] i.e. actual ROI divided by mod point target WACC = 10.39%/7.35% = 41%

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4. Mighty River Power[4] (MRP) estimates overcharging by Unison compared to the case had revenues been within the thresholds of $26.55m. The same point was made by MEUG[5] and by CC93[6].

Further information on an efficient target WACC

5. In the initial MEUG submission we requested an explanation of why the Commission was prepared to accept the Unison implied target WACC for the balance of the current 5-year threshold regime of 9.1% whereas the Commission mid point estimate is 7.35% and upper range estimate is 8.45% (all nominal post-tax).

6. Confirmation that the Commission's mid point estimate is still valid has been observed in the Transpower advice to its customers, including Unison, made public on 4th December of the required transmission revenue for 2007/08. An important assumption in deriving that revenue requirement is the target WACC. Transpower advised its customers that the target WACC is 7.40%[7]. While Transpower and the Commission are still in discussion on a draft settlement and a final settlement will be subject to consideration of public submissions, MEUG believe it's likely the final target WACC for Transpower will not be more than 7.40%. This leaves the 9.1% proposed by Unison as an outlier and reinforces our initial submission that an explanation is needed to understand why this much higher target WACC should be acceptable.

7. MEUG note the effect of agreeing Unison should have a target WACC of 9.1% instead of 7.35% in perpetuity would be to increase the valuation of the business by 24%, i.e. the NPV of the free cash flows increases in proportion to the percentage rather than absolute value of the excess return[8].

Further questions on asset values used in the draft settlement

8. In the initial MEUG submission questions were raised (paragraph 6. g)) about why the cost allocation model assumed an asset value of $357.7m whereas the last published ODV pursuant to the Disclosure Requirements as at 31 March 2005 was $285.7m. The latest Disclosure Requirements report an ODV as at 31 March 2006 of $303.3m[9]. Most of the increase was due to new fixed assets over the year ($29m) net of depreciation ($12m). The asset value used in the cost allocation model is still 18% higher than the audited Disclosure Requirements ODV. This is a large difference and is likely to result in materially higher tariffs than if the Disclosure Requirements ODV had been used.

Re-balancing

9. Vector[10] questioned whether the Commission had a statutory right to seek tariff re-balancing. MRP[11] noted the risk that re-balancing would result in wealth transfers rather than any economic efficiency improvement. MEUG agree with MRP that the issue of re-balancing is difficult and caution needs to be taken. The overall Commission approach with respect to rebalancing as proposed by Unison in the draft settlement has, in the view of MEUG, been taken cautiously and prudently notwithstanding MEUG has important concerns about the inputs used in the cost allocation model.

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[4] MRP submission, paragraphs 45 and 46

[5] MEUG initial submission (paragraph 4) calculated every 1% excess return equaled overcharging of $4.25m pa. Summing the excess returns for the years ending 31 March 2004 to 2006 times $4.25m equals $28.8m

[6] CC93 submission, CC93 recommend an amended settlement counter-offer to Unison, 29 November 2006, page 3

[7] Transpower advice to its customers by generic letter, *Transmission Charges from 1 April 2007 to 31 March 2008 – Interim Advice*, 1 December 2006, attaching appendix K, *Year specific data, for year ending 31 March 2008*, Table K3 – Capital Rates

[8] The post-tax nominal annual cash flows will increase by (9.1%-7.35%)/7.35% = 24%. Therefore the overall value of the enterprise will increase by the same ratio.

[9] NZ Gazette, No. 157, *Unison Networks Limited, Information for disclosure pursuant to s.57T of the Commerce Act 1986*, 29 November 2006, p 4595

[10] Vector, *Submission on Reasons for Not Declaring Control of Unison*, 29 November 2006, paragraph 7

[11] MRP, *Submission to the Commerce Commission on draft decision: Reasons for not declaring control – Unison Networks Ltd*, 29 November 2006, section 7, paragraphs 51 to 83

10. The Commerce Commission when declaring an intention to control the Vector electricity line business summarised the issue of cross-subsidies and re-balancing as follows[12]:

> "In particular, the Commission is also mindful of the government's wider objective for infrastructure, as reiterated in the GPS, which is to "enhance infrastructure's net contribution to economic growth and societal well-being over time." Consequently, it is of particular concern to the Commission that many of the consumer groups disadvantaged by Vector's current pricing strategy are commercial and industrial customers. As the supplier of around one-third of New Zealand's electricity distribution services, Vector's pricing affects the costs for many businesses in the productive sector that have to compete nationally and/or internationally in markets for tradeable goods."

11. MEUG agrees with this quote that recognises excess line tariffs can have economic efficiency effects on the consumption and investment decisions of manufacturers'. To the extent cross-subsidies have economic welfare effects on consumers, then line tariffs are a legitimate focus for the Commerce Commission implementing Part 4A of the Commerce Act, i.e. MEUG disagree with the view of Vector that tariff re-balancing is not within the ambit of the Commission.

M&A incentives

12. MRP cautions that the Commission's approach to seeking re-balancing between regions may deter otherwise efficient mergers and acquisitions occurring because newly expanded businesses would have legacy tariffs still to deal with[13]. MEUG disagrees. Mergers and acquisitions should occur where one entity observes cost savings are possible while remaining within thresholds. Without any threshold breach, the newly expanded entity will have time to deal with legacy tariff issues.

13. MEUG is not sympathetic towards distributors that acquire other networks at a price above ODV values and then find themselves with cash flow problems.

What happens following 31 March 2009?

14. The current thresholds expire 31 March 2009 and the Commission have indicated work to have revised thresholds from 1 April 2009 will commence in the second half of 2007. Vector suggested[14] the regime post 31 March 2009 "will be informed by the outcome of the review of Parts 4, 4A and 5 of the Act currently being undertaken by the Ministry of Economic Development."

15. MEUG believe it unlikely that the Government could reach a final decision on Commerce Act changes by August 2007 (per the timetable announced by the Minister of Commerce earlier this year), have legislation drafted and passed early 2008 to give sufficient time for the Commission to implement significant changes to the regime to be operable by 1 April 2009. However there is a possibility the government might try to force that outcome. This will create significant uncertainty to end consumers about whether excess returns distributors have gained over this first 5-year threshold period will subsequently be shared or whether legislative changes will change the rules of the game. This uncertainty needs to be clarified by the government declaring clearly whether the current reviews of Parts 4, 4A and 5 of the Commerce Act is intended to alter the threshold reset from 1 April 2009.

16. The relevance to the proposed Unison settlement is that the Commission is asking consumers to forgo more than $25m of excess charges over the last 3 years plus excess returns for the next 2 years on the assumption the reset on 1 April 2009 will share benefits taking into account the first 5 years. However if the rules for the regime change from 1 April 2009, then the Commission cannot guarantee it can deliver that part of the bargain from 1 April 2009. This leaves consumers at risk of losing out now and from 1 April 2009.

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[12] Commerce Commission, Regulation of Electricity Lines Businesses, Targeted Control Regime, Intention to declare control, Vector Limited, 9 August 2006, paragraph 206, p54

[13] MRP, *Submission to the Commerce Commission on draft decision: Reasons for not declaring control – Unison Networks Ltd*, 29 November 2006, section 5.2, paragraphs 36 to 41.

[14] Vector, *Submission on Reasons for Not Declaring Control of Unison*, 29 November 2006, paragraph 6

Concluding comments

17. The information provided by Unison in the draft settlement and the Commission analysis of the draft is incomplete. The initial MEUG submission asked for information and explanations on a number of issues to ensure the proposal is robust. In this cross-submission additional questions are raised. MEUG recommend the Commission only accept a final settlement once the level of information provided by Unison is complete and the analysis and reasoning of accepting settlement (instead of control) are much clearer than the paper released 9 November 2006.

Yours sincerely

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