MAJOR ELECTRICITY USERS' GROUP

31 July 2009

Karen Murray
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By email to NPB@comcom.govt.nz

Dear Karen

Submission on Input Methodologies Discussion Paper

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission's, "Input Methodologies Discussion Paper," published 19th June 2009[1] (the "IM Discussion paper"). Changes to Part 4 of the Commerce Act[2] last year require the Commission to publish Input Methodologies for various regulated sectors no later than 30th June 2010. This submission focuses on the requirement to publish Input Methodologies for Electricity Distribution Businesses (EDB) and Transpower.

2. For EDB and Transpower the Input Methodologies have a bearing on mandatory information disclosure requirements and the regulatory options comprising default or customised Price-Quality Regulation, or Individual Price-Quality Regulation. The reference to EDB covers both exempt and non-exempt EDB where an exemption refers to consumer-owned EDB that are subject only to information disclosure[3].

Cost Allocation between Business Units for EDB[4]

3. The proposal by the Commission to use the existing cost allocation handbook for determining costs to be allocated to an EDB is pragmatic. We agree a companion cost allocation handbook be developed by the Commission where a business owns multiple regulated business units.

Initial and ongoing Regulatory Asset Base for EDB[5]

4. The Commission propose using the 2004 Optimised Deprival Valuations (ODV) for system fixed assets plus additions and disposals since that date indexed at CPI to 2010 for the initial Regulatory Asset Base (RAB). Easements are to be valued at historic cost (or nil if no cost) with no indexation. Non-system fixed assets are to be valued using Generally Accepted Accounting Practice (GAAP).

5. The initial RAB will be rolled forward using the Consumer Price Index (CPI).

6. MEUG has two comments on the above preliminary views of the Commission on the initial RAB and rolling forward policy for EDB as follows:

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[1] Refer http://www.comcom.govt.nz/IndustryRegulation/Part4/DecisionsList.aspx
[2] Refer http://www.legislation.govt.nz/act/public/1986/0005/latest/DLM87623.html
[3] Commerce Act s.54G
[4] IM Discussion paper p 318 to 323
[5] Ibid p 323 to 337

a) The tight legislative timeframe for completion of Input Methodologies and Default Price-Quality Paths has eliminated the more thorough option of ODV to reset the RAB as at 1st April 2010. There is a risk that the Commission will, in the absence of precise valuation information, either over or under value RAB for each EDB. For example CPI may not be the best index for existing capital. The Input Methodologies need to have a mechanism to mitigate this risk and to provide a sanity check that CPI is the best index and additions and deletions since 2004 have been least cost to meet the needs of consumers. For example random sampling testing and analysis of capital additions since 2004 would corroborate (or not) if the assumption all additions can reasonably be added to the RAB. If not, a scaling factor should be applied to actual additions based on the sampling analysis.

b) Developing incentives on EDB to prepare useful and accurate Asset Management Plans (AMP) and to be accountable in later years for prior AMP is an important mechanism to mitigate gold plating and to ensure consumers receive the level of service that they pay for. This is to be developed by the Commission in consultation on Information Disclosure. This is an example where the final Input Methodologies and Information Disclosure regimes need to be carefully meshed together.

Regulatory Treatment of Tax for EDB[6]

7. MEUG has no comment on the preliminary view of the Commission to assume actual tax.

Pricing Methodologies for EDB[7]

8. MEUG's submission to the Commission on Reset of Default Price-Quality Path for EDB[8] (dated 17th July 2009) noted the merits of regulation being price specific to better match individual consumer price and quality trade-offs[9] as opposed to covering aggregate revenues; though at increasing transaction costs. Customised or Individual Price-Quality Regulation would cover specific regulated pricing whereas Default Price-Quality Regulation would be at the aggregate revenue level or, as we have suggested, maximum pricing levels for major consumer groupings (eg voltage classes).

9. The Consumer Coalition on Energy (CC93) submission[10] to the Electricity Commission dated 10th July 2009 on Distribution Pricing Methodology argued those pricing models should be mandatory. MEUG's separate submission reinforced the view of CC93.

Cost of capital for EDB

10. Attached to this submission is a report by Ireland, Wallace & Associates Limited (IWA) "Input Methodologies Discussion Paper Submission" dated 31st July 2009. IWA have considered the Commissions' discussion and preliminary views on the cost of capital in three related documents:

a) The IM Discussion Paper[11];

b) Commerce Commission, "Revised Draft Guidelines – The Commerce Commission's Approach to estimating the Cost of Capital", 19th June 2009[12]; and

c) Professor Julian Franks, Dr Martin Lally and Professor Stewart Myers, "Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology", dated 18th December 2008 and published by the Commerce Commission 19th June 2009[13].

11. The key recommendation in paragraph 7.1 of the IWA report is (where L=Leverage):

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[6] Ibid, p 337 to 338
[7] Ibid, p 338 to 343
[8] Refer http://www.comcom.govt.nz/IndustryRegulation/Electricity/PriceQualityPaths/20102015defaultpricepath.aspx
[9] Commerce Commission, Reset of Default Price-Quality Path for EDB Discussion paper, 19th June 2009, paragraph 47: "*Consumers respond to the prices that they face, rather than to the revenues that firms make. Similarly, service quality is more important to consumers at an individual service level than on a whole-of-business basis*."
[10] Refer http://www.electricitycommission.govt.nz/submissions/substransmission/distrib-pricing
[11] IM Discussion paper, Chapter 8: The Regulatory Cost of Capital (p 224 to 262), and in relation to EDB, p 343 to 344.
[12] http://www.comcom.govt.nz//IndustryRegulation/Part4/ContentFiles/Documents/Revised%20Draft%20Guidelines.pdf
[13] http://www.comcom.govt.nz//IndustryRegulation/Part4/ContentFiles/Documents/Expert%20panel%20report%20(2)%20(2).pdf

> "The Commission should adopt a default position of L = 0% for ex ante WACC determinations. If WACC is based on L = 0% the calculation of the cost of capital is simplified, as assessing the cost of debt is avoided. Also, greater certainty in the calculation of WACC is attained.
>
> Supplier firms are able to proceed under a customised/individual price-quality path process and thereby able to present specific proposals to the Commission including arguments justifying WACC model and application including L. [IM Chapter 14]
>
> The net benefits of debt claimed should be justified by the supplier/owner through the customised/individual price path process and not the Commission. The default position of L = 0% should apply. While agreeing with Dr Lally that there are many theories and sometime controversial views on capital structure, it beholds the Commission to consider them. If they can't be reasonably quantified or supported by relevant empirical evidence, then they should be dismissed by the Commission."

12. The final paragraph of the IWA report states:

> "The Commission can improve Part 4 outcomes, better satisfy WACC principles and not adversely affect social net benefit by simply assuming L = zero for calculating ex ante WACC. Just one change is required to better achieve Part 4 Purpose outcomes."

13. MEUG support the recommendations of IWA on this key issue.

14. In relation to other aspects of the Commissions preliminary view on cost of capital in the IM Discussion Paper:

    a) MEUG agrees that the final generic Cost of Capital Guidelines to be decided by the Commission in early 2010 should form the framework for the cost of capital Input Methodologies for EDB and Transpower[14]. MEUG disagrees that the draft Cost of Capital Guidelines published concurrent with the Input Methodologies Discussion paper meets the requirements of Part 4 of the Commerce Act, refer the IWA report attached[15].

    b) MEUG notes the Commission's preliminary view on a number of factors is to skew any bias in favour of EDB at the expense of consumers, eg

        i) Because of estimation error for WACC parameters, the Commission may choose a WACC above the mid point normal rate of return[16];

        ii) Using a WACC above the mid point for any uncompensated asymmetric or unsystematic risks[17]. MEUG notes the Commission presents no empirical evidence of the magnitude of these "risks" for EDB.

    In such cases of uncertainty, the Commission should exercise bias provided it is necessary in terms of the objectives of Part 4 and some estimation of the benefit or justification of the bias underpins the decision. Without analysis of the costs and benefits of moving away from a mid-point estimate, any bias is simply a guess that benefits will exceed costs. The Commission in assessing costs and benefits needs to be mindful of the information asymmetry between itself and the EDB and the risk of gaming and opportunistic behaviour by EDB.

    Analysing the costs and benefits of assuming other than mid-point estimates also raises the problem of assessing the cumulative effect where a number of factors are biased in favour of EDB at the expense of higher line charges to consumers.

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[14] IM Discussion Paper Q.108, p226
[15] To avoid any uncertainty, note the recommendations of the IWA report apply to the cost of capital Input Methodology for EDB, Transpower and all other businesses regulated under Part 4.
[16] Ibid, paragraph 8.19, p227
[17] Ibid, Q.119, p240

c) Use of a "vanilla WACC" is acceptable[18] although to ensure there is no misinterpretation the Commission should always publish a post-tax WACC equivalent alongside the vanilla WACC.

d) MEUG agrees with the Commission's preliminary view that an industry-wide cost of capital is appropriate[19]. EDB can request a be-spoke cost of capital as part of a Customised Price-Quality path application.

e) The discussion on the proposed asset beta[20] in effect says the asset beta depends on the type of "regulatory contract set in legislation" between the regulated entities and regulator, ie where in the spectrum between low-powered incentives and high-powered incentives does the regulatory regime fit. MEUG suggest the analysis also needs to consider the terms and conditions of contracts between the regulated entities and their customers because how risk is managed in those contracts may have a bearing on the relative asset beta for the Input Methodologies WACC. For example an EDB with a regulated asset beta of 0.3 may through contracting effectively pass most of the risk to other parties resulting in an effective lower asset beta but still have regulated prices as if the business had an asset beta of 0.3.

f) We are interested in the views of EDB on evidence to support any change to how WACC should be computed as a result of the global financial crisis. MEUG emphasis that submissions based on evidence and empirical analysis are essential on this issue. Claims of vague national interest to invest in infrastructure because of the current crisis are outside the scope of Part 4.

If the Government believes more infrastructure is needed than that required in terms of Part 4, then the Government should subsidise a higher scale of infrastructure spend (eg the reported accelerated $50m operating and maintenance spend by Transpower[21]) to meet those other policy objectives.

Regulatory Processes and Rules for EDB[22]

15. In the MEUG submission to the Commission on the Reset of Default Price-Quality Path for EDB of 17th July 2009, we suggested an alternative view on costs that should and should not be considered as pass-through costs. That is Commerce Commission levies, Electricity Commission levies and Transmission Interconnection charges be treated as pass-through costs. Local authority rates and Transmission Connection Charges should not be treated as pass-through costs. An alternative of less than full cost pass-through was noted in the IM Discussion Paper[23] but dismissed. There may be merits in re-considering this for the costs MEUG have previously submitted should not be full cost pass-through; for example as an intermediate step to removing those items completely from being allowable pass-through costs.

16. MEUG agrees with the preliminary view of the Commission that there should be no scope for re-openers under Default Price-Quality regulation. Re-openers can be considered under Customised Price-Quality Regulation and is one reason why EDB may decide to pursue that option.

Input Methodologies for Transpower

17. The following comments should be read in conjunction with the separate MEUG submission to the Commission "Transpower Process and Recommendation Discussion Paper" lodged today.

18. MEUG agrees with the Commission's preliminary views on[24]:

a) Adopting the same approach as the Transpower Settlement[25] for allocating System Operator costs[26];

[18] Ibid, Q.109, p230
[19] Ibid Q.111, p230
[20] Ibid Q.114 and Q.115, p236
[21] Hon Gerry Brownlee, Minister of Energy and Resources, media release, "National Grid Upgrade", 12th February 2009, refer http://www.beehive.govt.nz/release/national+grid+upgrade
[22] IM Discussion Paper, Ibid, p 344 to 347
[23] Ibid, paragraph 12.317, p405
[24] Some issues MEUG has no comment on at this stage such as proposed regulatory treatment of tax for Transpower Input Methodologies, refer IM Discussion Paper p398.

b) Adopting the same approach as the Transpower Settlement for the initial Regulatory Asset Base[27];

c) Revenue, costs and service levels agreed bi-laterally in New Investment Contracts between Transpower and its customers being excluded from Individual Price-Quality Regulation. MEUG agrees with the Commission proposal that for New Investment Contracts entered into after 5th June 2003, those contracts be excluded only if the other party[28] "*agrees in writing that the terms and conditions are reasonable or reflect workable or effective competition for the provision of the goods and services*."

d) Consideration be given to allowing Transpower to earn a margin representing efficiency gains in operating costs relative to an ex ante forecast[29]. However the Commission must be absolutely sure that giving Transpower a near-term benefit, in effect a higher cost to consumers, will result in superior performance against that of an efficient business in the longer-term. This should be a matter of careful empirical analysis to benchmark Transpower's current relative performance to that of the most efficient peer business and to track performance over time to ensure there is a payback to consumers.

e) The Commission referring to the Transmission Pricing Methodology for Transpower approved by the Minister and gazetted on the recommendation of the Electricity Commission as the appropriate pricing Input Methodology[30];

f) The need to recognise the complexity of establishing a quality standard[31] that will mesh with the numerous other standards in place. Those include the Transpower Settlement quality thresholds, the Benchmark Agreement performance standards and the Grid Reliability Standard. This work-in-progress is probably the most demanding of all the Input Methodologies required for Transpower. Because quality and price are interrelated, the Input Methodology needs to provide for a mechanism to link these two factors.

g) The proposed one year transition from 1 July 2010 based on the Settlement followed by an initial Individual Price-Quality Path of 4 years[32].

h) The Transpower Input Methodology should describe the characteristics rather than have a prescriptive list of specific events that would trigger reconsideration of price and quality paths under Individual Price-Quality Regulation[33]. Re-opening one path, such as price, should automatically lead to re-opening the other path because both should be interrelated.

19. MEUG has a different view to the Commission's preliminary views on the following:

a) In relation to other matters relevant to a building blocks approach[34], the capital expenditure review, approval and inclusion in the regulatory asset base would need to consider the age and condition of assets. The planned capital expenditure over a four year term would be established on the basis of the age, condition and environment in which the assets are situated. MEUG's understanding is that Transpower's current planning for capital expenditure may not be sufficient to provide accurate inputs.

b) MEUG considers that the Commission should be cautious regarding the treatment of stranded assets[35]. This view has been taken because:

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[25] "Transpower Settlement" refers to the settlement agreed in lieu of Transpower being controlled.
[26] IM Discussion paper, p 357 to 360
[27] Ibid, p 360 to 364
[28] Ibid, p393
[29] Ibid, p397
[30] Ibid, p 398 to 400
[31] Ibid p 402
[32] Ibid p 404
[33] Ibid p 405
[34] Ibid, Q 183) "*What other matters do you consider are relevant to the determination of Transpower individual price-quality path using a building blocks approach? Please provide details*", p357
[35] Ibid, Q.186) "*In your view, should Transpower be compensated for stranded assets, when the stranding is caused by factors that are outside its control? Please provide the reasons for your view*", p366

i) Determining what is 'beyond Transpower's control' may be difficult to achieve in practice because Transpower can, and currently does, take actions to avoid the stranding of its assets.

ii) For connection assets Transpower can pass the risk of stranded assets to its customers via a New Investment Agreement.

iii) There is an existing facility called 'Prudent Discounts' that provides Transpower with the ability to discount transmission charges to customers that have the potential to by-pass and strand Transpower's assets. This mechanism avoids inefficient duplication of assets.

iv) The stranding risk for interconnection assets would logically be in the large investments that are subject to Electricity Commission approval under Part F of the Electricity Governance Rules. Smaller asset replacement and refurbishment capital expenditure is unlikely to face stranding risk.

MEUG considers that the current facilities for dealing with the potential for stranded assets are likely to be sufficient and also provide Transpower with the incentives to manage this risk appropriately. Providing an option that removes the asset stranding risk from Transpower may also transfer the incentive to claim 'beyond Transpower control' rather than manage the risk.

c) Comments on the cost of capital for EDB in paragraphs 10 to 14 of this submission also apply to the cost of capital for Transpower[36].

d) MEUG does not agree that rates on system fixed assets should be treated as pass through costs[37]. Where Transpower considers rating costs excessive in a particular region then it should consider lodging an objection with that rating authority just as any other business would. This is a cost of doing business in that area and Transpower should be treated no differently. MEUG agrees Electricity Commission levies should be treated as pass through costs.

Concluding comments

20. This submission is not confidential. We look forward to participating in the cross-submission round and conference.

Yours sincerely

Ralph Matthes
Executive Director

[36] Ibid, p400
[37] Ibid, p404