



MAJOR ELECTRICITY USERS' GROUP

27 September 2010

Matthew Lewer
Regulation Branch
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Mr Lewer

Cross-submission on starting price adjustments for Default Price-Quality Paths

1. This is a cross-submission by the Major Electricity Users' Group (MEUG) on the submissions by fourteen other parties that closed 10th September in relation to the Commerce Commission discussion paper "Starting price adjustments for Default Price-Quality Paths" (DPP) published 5th August 2010¹.
2. Twelve of the other submissions were from electricity or gas lines businesses, one from a consultant and one from an electricity supplier, namely Contact Energy. The submission from the consultant was on cost of capital rather than starting price adjustments for DPP. The submission from Contact Energy supports efforts by the Commerce Commission to implement the purpose of Part 4 of the Act (refer s.52). MEUG welcome involvement by electricity suppliers in so far as they are acting in the interests of end consumers. The submission by Contact Energy partially paraphrases s.52 and appears to have used the phrase "efficient pricing to users" as shorthand for subsections 52(1)(c) and 52(1)(d) that require the Commission to develop a regime that ensures efficiency gains are shared with consumers and Part 4 regulated entities are limited in their ability to extract excessive profits.
3. The submissions by the remaining twelve lines businesses had several common themes including a view starting price adjustments should be an Input Methodology, a preference for the Commission to include more forward looking data for DPP, uncertainty on how the details would work and hence more consultation including possibly a conference. MEUG has no view, at this stage, on these items.
4. Overall having read the submissions of the other parties, MEUG's views set out in our original submission of 10th September remain unchanged. There are two matters mentioned in submissions that are commented on below. This submission concludes with an initial analysis of the effect of pricing by comparing reported Return on Investment to date compared to an ex ante cost of capital.

¹ <http://www.comcom.govt.nz/2010-2015-default-price-quality-path/>

Treatment of discounts/distributions as noted by Network Tasman

5. Network Tasman Limited (NTL) stated²:

“NTL regards the comparative treatment of Posted and Discretionary Discounts to be inconsistent, irrational and problematic. There are significant inconsistencies and discrepancies in Po adjustments depending on the type and quantum of the discount applied. Additionally the relative outcomes between discount and dividend /retention models are also inconsistent.”

6. If Network Tasman Limited is correct then this is an issue that needs to be solved.

WEL target of WACC plus 1.5% for investing in the network

7. In support of a band above WACC WEL Networks stated³:

“Our board has set a target for some years of WACC plus 1.5% as the appropriate setting for investing in the network.”

8. This begs a number of questions such as whether the WEL Network Board determined WACC, before the addition of 1.5%, was a mid-point estimate, or the 75th percentile or some other range, or whether it was a proxy for a debt premium and therefore how it might or might not integrate with the notion of a dead band proposed by the Commission. MEUG suggest publication of the details of the exact formula set by the WEL Networks Board would be helpful to understand current practices.

Comparison of Actual Return on Investment versus ex ante WACC

9. In the appendix attached is an estimate of the impact on prices paid by consumers after comparing actual Return on Investment (ROI) against an ex ante set cost of capital (WACC). This analysis is an estimate because several of the parameters are estimates rather than known data. The purpose of this initial estimate was to determine if recent ROI under the thresholds regime were broadly aligned or not with ex ante WACC estimates. The results of this initial analysis show:

- a) At an assumed 75th percentile ex ante WACC, eighteen EDBs had cumulative ROI expressed as profits over the last three years in excess of ex ante WACC. The additional profits grossed up by tax to give the effect on prices totalled \$577m.

There were 10 EDBs that had cumulative profits below WACC (value impact on prices paid of \$109m) and one EDB with a ROI equal to WACC over the three years.

The net sum of the impact on prices paid due to profits in excess of WACC less profits below WACC was \$468m over three years.

- b) Using the 50th percentile WACC calculated for each year, twenty two EDBs had prices due to cumulative profits over above WACC. The total summed to \$1,007m. Five EDBs were below WACC (\$40m) giving a net sum of prices due to profits in

² <http://www.comcom.govt.nz/assets/Gas/Gas-Default-Price-Quality-Path/Starting-Price-Adjustments/Network-Tasman-Submission-on-Starting-Price-Adjustments-for-Default-Price-Quality-Paths-for-Discussion-Paper-10-September-2010.pdf> , paragraph 17

³ <http://www.comcom.govt.nz/assets/Gas/Gas-Default-Price-Quality-Path/Starting-Price-Adjustments/WEL-Networks-Submission-on-Starting-Price-Adjustments-for-Default-Price-Quality-Paths-for-Discussion-Paper-10-September-2010.pdf>

excess of WACC less profits below WACC of \$967m over three years. Two EDB had ROI almost exactly equal to WACC.

10. MEUG note that high prices resulting from cumulative profits in excess of WACC as estimated in the appendix may be due to a number of factors, including or a combination of:
 - a) Efficiency gains by EDBs over and above that expected when the threshold regime was set;
 - b) The original thresholds being too generous to EDBs;
 - c) Excessive profits earned by EDBs; and
 - d) Issues with inconsistency in reported ROI as noted in paragraph 5 above.
11. Whichever of these applies, the net result of this initial analysis is that most end consumers can expect a decrease in EDBs prices.
12. From this initial analysis MEUG conclude that there is a material difference between the thresholds WACC and actual reported ROI that needs further investigation. Understanding why there is such a material difference and why the spread of profits around WACC is skewed to the upside rather than downside should assist the Commission in setting starting price adjustments and the "X" for the CPI-X applicable to the balance of the initial Part 4 Regulatory Control Period.
13. This submission is not confidential.

Yours sincerely



Ralph Matthes
Executive Director

Appendix: Initial estimate of effect on EDBs profits and prices by comparing ex ante WACC with ROI for 2008 to 2010

Purpose

This is an initial estimate of the difference between ROI and WACC to determine likely materiality on prices paid by consumers and therefore need for further investigation.

Assumptions:

1. ROI for years ending 31st March 2008 and 2009 as reported by Commerce Commission. Regulatory Asset Base (RAB) as reported by Commerce Commission, refer <http://www.comcom.govt.nz/electricity-information-disclosure-summary-and-analysis/>
2. ROI for 2010 as reported in submission to the Commerce Commission by the Electricity Networks Association, "Submission on Method to Adjust DPP Starting Prices", 10th September 2010, p15, refer <http://www.comcom.govt.nz/assets/Gas/Gas-Default-Price-Quality-Path/Starting-Price-Adjustments/ENA-Submission-on-Starting-Price-Adjustments-for-Default-Price-Quality-Paths-for-Discussion-Paper-10-September-2010.pdf>
3. RAB for 2010 is assumed to be the same as RAB values for 2009. If the actual 2010 RAB values are greater than the 2009 RAB values, then the price effects estimated in this analysis will be understated.
4. Ex ante WACC calculated for each year using Reserve Bank 5 year Government Bonds in March prior to each Regulatory year starting 1st April, refer <http://www.rbnz.govt.nz/statistics/exandint/b2/index.html>

For all years standard assumptions are made for debt premium (1.8%), Tax Adjusted Market Risk Premium (7%), corporate and investor tax rates (30%), asset beta (0.34) and leverage (40%). The Simplified Brennan-Lally CAPM is used to derive a 50th percentile post-ax WACC. A further 1.5% is added to estimate the 75th percentile. The latter is very much an estimate and if anything at the high end of the margin to shift from a 50th to 75th percentile. The Commission proposed approach is used for this initial analysis even though MEUG in separate submissions on cost of capital Input Methodologies note the approach is flawed. Using the MEUG approach to the model would lead to higher dollar values for profits and price effects between ROI and WACC.

March Year end	2008	2009	2010
Post-tax WACC – 50 th percentile	7.44%	7.56%	5.70%
Post-tax WACC – 75 th percentile	8.94%	9.06%	7.20%

Table 1: Inputs	ROI			RAB		
March Year end	2008	2009	2010	2008	2009	2010
				\$m	\$m	\$m
Alpine Energy	10.13%	11.12%	8.01%	104	115	115
Aurora Energy	12.40%	11.49%	9.70%	253	275	275
Buller Electricity	4.83%	7.25%	7.28%	25	26	26
Centralines	4.73%	6.15%	6.22%	38	41	41
Counties Power	10.56%	7.29%	4.52%	154	171	171
Eastland Network	9.25%	9.26%	8.16%	107	111	111
Electra	3.79%	3.15%	1.98%	121	129	129
Electricity Ashburton	7.55%	8.76%	7.32%	143	154	154
Electricity Invercargill	10.07%	8.80%	7.83%	53	55	55
Horizon Energy Distribution	9.17%	11.09%	9.44%	86	90	90
MainPower New Zealand	10.46%	10.17%	7.15%	159	173	173
Marlborough Lines	5.98%	5.52%	3.41%	146	160	160
Nelson Electricity	11.02%	12.64%	8.62%	23	24	24
Network Tasman	9.26%	9.48%	8.64%	139	145	145
Network Waitaki	9.17%	8.57%	8.07%	61	64	64
Northpower	11.64%	7.46%	6.79%	175	194	194
Orion New Zealand	10.09%	10.02%	8.60%	716	757	757
OtagoNet Joint Venture	11.51%	11.23%	9.40%	107	113	113
Powerco	10.83%	11.23%	9.36%	1,101	1,162	1,162
Scanpower	10.48%	8.76%	7.04%	26	27	27
The Lines Company	8.25%	6.12%	6.03%	122	136	136
The Power Company	7.62%	7.57%	5.59%	250	264	264
Top Energy	7.77%	7.05%	4.72%	119	127	127
Unison Networks	10.13%	8.95%	8.93%	372	405	405
Vector	11.80%	11.60%	10.35%	2,368	2,212	2,212
Waipa Networks	11.50%	9.45%	9.09%	73	78	78
WEL Networks	13.78%	12.22%	10.95%	277	306	306
Wellington Electricity Lines	n/a	8.63%	11.49%	n/a	316	316
Westpower	10.41%	6.94%	5.30%	91	101	101
Total				7,409	7,933	7,933

Table 2: Results for 75 th percentile WACC	Profit effect, ie (ROI – WACC (75 th percentile))*RAB				Price effect (WACC 75 th percentile), ie Profit effect / (1-tax)			
March Year end	2008	2009	2010	Σ 08-10	2008	2009	2010	Σ 08-10
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Alpine Energy	1	2	1	5	2	3	1	6
Aurora Energy	9	7	7	22	13	10	10	32
Buller Electricity	-1	-0	0	-1	-1	-1	0	-2
Centralines	-2	-1	-0	-3	-2	-2	-1	-5
Counties Power	2	-3	-5	-5	4	-4	-7	-7
Eastland Network	0	0	1	2	0	0	2	2
Electra	-6	-8	-7	-21	-9	-11	-10	-29
Electricity Ashburton	-2	-0	0	-2	-3	-1	0	-3
Electricity Invercargill	1	-0	0	1	1	-0	0	1
Horizon Energy Distribution	0	2	2	4	0	3	3	6
MainPower New Zealand	2	2	-0	4	3	3	-0	6
Marlborough Lines	-4	-6	-6	-16	-6	-8	-9	-23
Nelson Electricity	0	1	0	2	1	1	0	2
Network Tasman	0	1	2	3	1	1	3	4
Network Waitaki	0	-0	1	0	0	-0	1	1
Northpower	5	-3	-1	1	7	-4	-1	1
Orion New Zealand	8	7	11	26	12	10	15	37
OtagoNet Joint Venture	3	2	2	8	4	4	4	11
Powerco	21	25	25	71	30	36	36	102
Scanpower	0	-0	-0	0	1	-0	-0	0
The Lines Company	-1	-4	-2	-6	-1	-6	-2	-9
The Power Company	-3	-4	-4	-11	-5	-6	-6	-16
Top Energy	-1	-3	-3	-7	-2	-4	-5	-10
Unison Networks	4	-0	7	11	6	-1	10	16
Vector	68	56	70	194	97	80	100	277
Waipa Networks	2	0	1	4	3	0	2	5
WEL Networks	13	10	11	35	19	14	16	49
Wellington Electricity Lines	n/a	-1	14	12	n/a	-2	19	17
Westpower	1	-2	-2	-3	2	-3	-3	-4
Total	122	79	126	328	175	113	180	468

Table 3: Results for 50 th percentile WACC	Profit effect, ie (ROI – WACC (50 th percentile))*RAB				Price effect (WACC 50 th percentile), ie Profit effect / (1-tax)			
March Year end	2008	2009	2010	Σ 08-10	2008	2009	2010	Σ 08-10
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Alpine Energy	3	4	3	10	4	6	4	14
Aurora Energy	13	11	11	34	18	15	16	49
Buller Electricity	-1	-0	0	-0	-1	-0	1	-0
Centralines	-1	-1	0	-1	-1	-1	0	-2
Counties Power	5	-0	-2	2	7	-1	-3	3
Eastland Network	2	2	3	7	3	3	4	9
Electra	-4	-6	-5	-15	-6	-8	-7	-21
Electricity Ashburton	0	2	2	5	0	3	4	6
Electricity Invercargill	1	1	1	3	2	1	2	5
Horizon Energy Distribution	1	3	3	8	2	5	5	11
MainPower New Zealand	5	5	3	12	7	6	4	17
Marlborough Lines	-2	-3	-4	-9	-3	-5	-5	-13
Nelson Electricity	1	1	1	3	1	2	1	4
Network Tasman	3	3	4	10	4	4	6	14
Network Waitaki	1	1	2	3	2	1	2	5
Northpower	7	-0	2	9	11	-0	3	13
Orion New Zealand	19	19	22	60	27	27	31	85
OtagoNet Joint Venture	4	4	4	13	6	6	6	18
Powerco	37	43	43	123	53	61	61	175
Scanpower	1	0	0	1	1	0	1	2
The Lines Company	1	-2	0	-1	1	-3	1	-1
The Power Company	0	0	-0	0	1	0	-0	0
Top Energy	0	-1	-1	-2	1	-1	-2	-2
Unison Networks	10	6	13	29	14	8	19	41
Vector	103	89	103	296	148	128	147	422
Waipa Networks	3	1	3	7	4	2	4	10
WEL Networks	18	14	16	48	25	20	23	68
Wellington Electricity Lines	n/a	3	18	22	n/a	5	26	31
Westpower	3	-1	-0	2	4	-1	-1	2
Total	233	198	245	677	334	283	350	967