MAJOR ELECTRICITY USERS' GROUP

5 September 2011

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

Dear Matthew

Cross-submission on 2010-15 Default Price-Quality Path for Electricity Distribution

1. This is a cross-submission by the Major Electricity Users' Group (MEUG) on submissions that closed 24th August regarding the Commerce Commission Draft Decisions Paper "2010-15 Default Price-Quality Path for Electricity Distribution" (DPP) dated 19th July 2011[1]. We cross-submit first on claw-back and second on comments by EDB that fail to recognise consumers come first.

Claw-back

2. MEUG submitted claw-back should be implemented. Centralines and Unison also submitted that claw-back should apply. Aurora and Vector supported the Draft Decision that claw-back should not apply.

3. The decision on whether to exercise the claw-back provisions is dependent on whether changes in Input Methodologies have a material effect. The same materiality test applies to implementing starting price adjustments and claw-back. One is a forward looking limb and the other the back-ward looking limb of the overall objective of ensuring EDBs a normal return and appropriate investment incentive over the full regulatory period, without either rewarding past inefficiency or distorting incentives for future investment.

4. Parliament has balanced any potential hardships to suppliers (and consumers) caused by the retrospective nature of claw-back by requiring that any adjustments be spread over time (s.52D). These hardships should not therefore be relevant to the Commission's decision whether to apply claw-back. Claw-back should apply automatically whenever a new Input Methodology results in a materially different DPP, prompting the Commission to reset the DPP under s.54K (3). Alternatively, this should at least be the default position; the Commission should then clearly set out any exceptional circumstances which would cause it not to apply claw-back.

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

5. Comments on the submissions of other parties follow.

Aurora submission[2]

> *"A clawback is not a forward–looking approach and beyond the ability of any EDB to manage. Therefore, it should not be resorted to. It is also inconsistent with best international regulatory practices."*

6. We agree claw-back is not a forward-looking approach because by definition a claw-back is backwards-looking. Managing a claw-back adjustment is unlikely to be any different from the uncertainty EDB face in managing starting price adjustments proposed for 1st April 2012. We therefore disagree claw-back "should not be resorted to" as submitted by Aurora.

7. The second sentence from the quote above that "it (ie claw-back) should not be resorted to" is effectively a submission that the Commission should never apply claw-back when resetting DPPs (at least, when it would be unfavourable to suppliers). This submission by Aurora is contrary to the Act which clearly anticipates that claw-back will apply if a new Input Methodology results in a materially different DPP, prompting the Commission to reset the DPP under s.54K (3) e.

8. No evidence is tabled by Aurora of "best international regulatory practices" with respect to claw-back. Given the bespoke nature of regulatory regimes around the world we think it unlikely there would be a robust and undisputed analysis that provided such a comparison of New Zealand's claw-back provisions. Even if the case were proven that claw-back was inconsistent with best international regulatory practice, it does not trump the requirement for the Commission to meet the s.52A purpose statement and use claw-back where differences are material.

Vector submission[3]

> *"Vector supports the Commission's draft decision not to apply claw-back, as this would cause substantial practical difficulties, inequity and reduced investment.*
>
> *Vector welcomes and supports the Commission's draft decision not to apply claw-back. As discussed in Vector's 16 May 2011 submission, applying claw-back would cause substantial practical difficulties, inequity and reduced investment. These difficulties are particularly strong in the absence of clearly established criteria for applying claw-back and a mechanism for implementing claw-back. Vector also agrees with the Commission that claw-back from EDBs that receive a price decrease is likely to involve clawback of efficiency gains made within the 2011 and 2012 regulatory years."*

9. Vector submitted four reasons as to why claw-back should not apply. The first three discussed below were first mentioned in the Vector submission of 16th May 2011. The last bullet point is a further reason from the Draft Decision paper that Vector agreed with.

- First "substantial practical difficulties". This is in effect the same argument by Aurora that claw-back is "beyond the ability of any EDB to manage." As noted in paragraph 6 above, "managing a claw-back adjustment is unlikely to be any different from the uncertainty EDB face in managing starting price adjustments proposed for 1st April 2012."

[2] Aurora submission, p10

- Second, "inequity" referring to a mismatch between past consumers that were over-charged and future consumers that receive lower charges as clawed back price reductions. That is no different from inequity with starting price adjustments. The more important factor is that all EDB consumers collectively will be better off with a generic DPP implementation of claw-back.

- Third, Vector said "reduced investment" would occur if claw-back were to apply and hence this was a reason that claw-back should not be implemented. MEUG does not understand why an EDB, if allowed an expected normal return over the entire regulatory period would not invest.

- Fourth, Vector supported the Draft Decision paper argument that claw-back, where actual line charges were higher than prices using normal returns, "is likely to involve clawback of efficiency gains made within the 2011 and 2012 regulatory years." MEUG agrees actual efficiency gains need to be credited to the EDB rather than included in the claw-back amount. The regulatory issue is therefore for the Commission to find a low cost estimate of efficiency gains consistent with the generic low cost approach required to implement DPP.

  An obvious estimate of actual sector efficiency is from the analysis in the Draft Decisions paper of the opex partial productivity growth[4]. Recent historic distribution industry efficiency improvements relative to the rest of the economy have been zero at best and possibly negative. In calculating claw-back, an economy wide productivity efficiency improvement factor for the last two years would be a reasonable estimate for the electricity distribution sector.

10. The analysis by Vector of the reasons for discarding claw-back is self-serving rather than consistent with the Act. As we submitted on 24th August, MEUG estimate Vector has over-charged consumers approximately $39m[5] for the first two years. Naturally Vector has an incentive to defend these accidental excess revenues.

11. Parliament though was alert to such accidental "rents" and hence included the provision for the Commission to use the claw-back provisions. As noted in paragraph 3 above, the decision on whether to exercise those provisions is whether changes in Input Methodologies have a material effect. MEUG's estimate that consumers have been over-charged approximately $39m[6] over the first two years is highly material.

12. There is an underlying theme in the submissions by Vector that claw-back in effect should never be considered. This suggestion was also put by Aurora and we have rebutted that in paragraph 7 above. Vector avoid the question of when would claw-back apply. As we note in paragraphs 3 and 4 at the start of this cross-submission, claw-back and starting price adjustments are both triggered by materiality. Claw-back should apply automatically when there is a material difference post a change in Input Methodology. Alternatively claw-back should be the default position and the Commission should clearly set out any exceptional circumstances which would cause it <u>not</u> to apply claw-back.

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[3] Vector submission, paragraph 140, p37

[4] Draft Decisions paper, appendix C, paragraphs C53 to C57

[5] In the MEUG submission of 24th August 2011 in the second to last sentence of paragraph 4 we incorrectly referred to the estimate of $39m as "excess profits". This should have been referred to as excess line charges paid by consumers.

[6] This estimate may be a lower bound because we assumed a very generous 10% efficiency assumption.

Centralines submission[7]

> *"The Commission should apply claw-back to returns in the first two years of the regulatory period. Through the delay in the 2009 reset, Centralines has been disadvantaged in continuing its progress to making a full commercial return. Centralines submits that the Commission needs to provide transparency about the cost considerations it has applied in determining that it would be "too costly" to establish claw-back amounts. Also, why it considers that adverse incentives may be created by applying claw-back, as the Commission can readily ensure that no EDB earns less than its regulated WACC."*

13. MEUG agrees with Centralines that claw-back should be applied. As the Centralines and Unison submissions are similar, comments on both are covered under the Unison heading.

Unison submission[8]

a) *"Disagrees that claw-back should not apply. We submit that the Commission has overstated the costs of calculating claw-back, and has not justified its conclusion that claw-back would detrimentally impact on incentives. The Commission has applied claw-back in the past (Gas Authorisation) in the same circumstances (mid-period reset) without any apparent negative impact on incentives to invest. We ask that the Commission be transparent about the basis for its reasoning and conclusions in respect of claw-back;*

b) *In the alternative, if the Commission continues to reject claw-back, Unison submits the Commission should reverse the GST adjustment to CPI. If the Commission is to apply a consistent approach to claw-back, then it should not make retrospective ad hoc adjustments which suppress returns in the 2011 disclosure year;"*

14. We cover the last point first. MEUG disagrees that if claw-back is not implemented then neither should the GST change in 2010 adjustment to CPI in the CPI-X formula be applied. Not adjusting for GST will increase charges across all EDB at the expense of consumers. The driver for Unison making this suggestion is that they think they deserve a break should they not get claw-back. MEUG see no reason to trade-off a general measure as a concession to minority interests; in this case EDB that have under-charged for the first two years until Input Methodologies were finalised. This reinforces the need for the Commission to deal with the underlying issue; namely claw-back for EDB that have under-charged should be considered.

15. MEUG agrees with Unison and Centralines that claw-back should apply. In addition the view of MEUG has changed regarding claw-back of over or under-charging. In our submission of 24th August we suggested that under and over-charging need not be treated symmetrically. After considering submissions of other parties we believe that treatment of prior under and over charging needs to be treated the same. Implementation will differ because the Commission will need to be satisfied when deciding a positive claw-back adjustment to future prices that less than normal profits to date have not been a result of inefficiencies.

[7] Centralines submission, p2

[8] Unison submission, paragraph 5, p3

Consumers come first

16. The s. 52A purpose statement is to promote the long-term benefit of consumers. Submissions by two EDB are reminders that some EDB do not understand that consumers come first. First, Aurora submitted[9] with underlined text emphasised by MEUG:

> *"However, what is most important, in Aurora's view, is that the Commission should now place a major effort and emphasis on developing and documenting the details of the regulatory methodology and its application for the next regulatory period. Aurora would suggest that this becomes the first task for the Commission and EDBs together in the regulatory process for the next regulatory period before the commencement of the implementation of the regulatory process. Aurora would welcome an opportunity to contribute to this process."*

17. Aurora should be asked why they did not consider consumers should be part of developing the reset for the 2016-2020 regulatory period?

18. Second, Vector submitted[10]:

> *"the Commission not release information to market analysts regarding Vector before it has released that information to Vector, and adopts Australian regulatory practice of releasing consultation and draft decision papers to affected companies 2-3 days prior to their release for general consultation."*

19. MEUG agrees with Vector that the Commission should not release information to market analysts before that information is released to EDBs. MEUG disagrees with the suggestion by Vector that EDBs should be privy to information before other parties, whether consumers or other interested public bodies such as NZX and analysts.

Yours sincerely

Ralph Matthes
Executive Director

[9] Aurora submission, p4

[10] Vector submission, paragraph 13(f), p6