



# MAJOR ELECTRICITY USERS' GROUP

24 August 2011

Matthew Lewer  
Commerce Commission  
By email to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

Dear Matthew

## Submission on 2010-15 Default Price-Quality Path for Electricity Distribution

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission Draft Decisions Paper "2010-15 Default Price-Quality Path for Electricity Distribution" dated 19<sup>th</sup> July 2011<sup>1</sup>. This submission focuses on the Starting Price Adjustment (SPA) proposals.
2. The consultation paper notes how favourable the SPA draft decision is for the 16 Electricity Distribution Businesses (EDBs) covered by this Default Price-Quality (DPP) regulation, eg:

*"why, as a result of the recent fall in the risk-free rate and debt premium, we consider that the real rate of return that we have allowed each EDB is already significantly above the rate of return currently required to incentivise investment"*<sup>2</sup>

*"It is reasonable to assume that EDBs that remain on the DPP believe it is broadly consistent with them having the ability to earn at least a normal return over the regulatory period. These EDBs may even expect to earn more than a normal return, because DPPs do not fully reflect each EDB's particular circumstances and customers do not have the right to see a CPP if they think prices are too high."*<sup>3</sup>

*"The risk of setting the DPP too low for any individual EDB is limited at present because we have provided all EDBs with a rate of return for the next three years that is significantly higher than investors currently require for that period."*<sup>4</sup>

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

<sup>2</sup> Draft decisions paper, paragraph X.16 and paragraph 2.26, bullet point 4

<sup>3</sup> Ibid, paragraph 1.51

<sup>4</sup> Ibid, paragraph 2.43

3. It seems to us there is scope to create stronger incentives on EDBs to become efficient given the head room between the cost of capital decided in 2009 that includes a bias favourable to EDBs by use of the 75<sup>th</sup> rather than 50<sup>th</sup> percentile WACC, and the actual significantly lower cost of debt now. The draft decision creates little pressure on the EDBs as they will all earn at least a normal rate of return even if they make no efficiency gains. In that environment the likelihood of EDB applying for a Customised Price-Quality Path (CPP) diminishes. If nil or very few CPP applications are lodged then that will indicate the SPA has been set too favourable to EDBs. This is an outcome the Commission should attempt to avoid.
4. One specific policy where the interests of consumers could be revisited is the treatment of claw-back of excess profits between 1<sup>st</sup> April 2010 and 31<sup>st</sup> March 2012. For some EDB this is material. For example the Commission estimates for Vector the PV difference between revenue required to earn a normal return over 2010-15 and revenue projected for the same period without a SPA would be \$110m<sup>5</sup>. MEUG has not calculated the year by year excess revenues nor do we know the fraction attributable to efficiency gains relative to average industry efficiency improvements. As an approximation if 10% is assumed as efficiency gains and two fifths of the \$110m relates to the period prior to SPA on 1<sup>st</sup> April 2012, then approximately \$39m of revenues for the two years ending 31<sup>st</sup> March 2012 are excess profits that Vector will receive that the Commission has decided will not be subject to claw-back. This is a very material sum.
5. The draft decisions paper reason for not applying claw-back is<sup>6</sup>:
 

*"We therefore do not consider that claw-back should be applied in these cases as it could, given this is a reset within period, result in outcomes which may not be in the long-term interests of consumers."*
6. MEUG suggests there is a very strong case for applying a claw-back. Implementing claw-back does not have to be symmetrical between historic over and under-charging compared to normal returns. EDBs suffering from historic lower than normal returns can apply for a CPP that will consider returns over the entire 2010-15 regulatory period. There is therefore no need to grant claw-back to those that have recorded less than normal returns to date. EDBs that have received higher than normal returns to date will not apply for CPP and therefore will, without a claw-back provision, make windfall gains. Consumers do not mind EDBs making returns greater than normal provided they earn it. A wind fall gain without an efficiency benefit by an EDB is not consistent with the purpose of the Act. MEUG recommends the Commission include in the SPA a claw-back of material positive excess revenues up to 31<sup>st</sup> March 2012 and those excess revenues accrue to consumers by way of lower prices over the remaining three years of the regulatory period.
7. Our last point relates to the integrity of the model and data used and the case for ex post reviews. The Commission is to be congratulated on being transparent with the model used and data sources. The greater accuracy in calculating present values of revenue and costs during a year, with tax at year end, we agree is more realistic. Inevitably with a project this large and complex various corrections will be needed. The register of model inquiries and actions has been useful and we support suggestions from EDBs for an independent validation of the model.

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<sup>5</sup> Ibid, Figure 2.4

<sup>6</sup> Ibid, paragraph 2.55

8. As the DPP is implemented the Commission should consider an annual review of the actual versus forecast outturn and monitor material differences. The value of an annual ex post review will be to inform the Commission and interested parties on strengths and weaknesses of the model and data and areas to focus on for future resets.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. Matthes', with a stylized flourish at the end.

Ralph Matthes  
Executive Director