
Submission

In response to the Commerce Commission's

**Open letter on our proposed scope, timing
and focus for the review of input
methodologies**

15 August 2014

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1 Introduction

Aurora Energy welcomes this opportunity to respond to Commerce Commission's "Open letter on our proposed scope, timing and focus for the review of input methodologies", 27 February 2015.

If the Commission has any queries regarding Aurora's submissions, please do not hesitate to contact Alec Findlater:

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2 Opening Comments

We support the submissions made by the Electricity Networks Association and PricewaterhouseCoopers. In particular, we share the view that the completion of the Input Methodologies (IM) review should not be brought forward from the statutory deadline of 2017.

We note substantive components of the IMs were reviewed through the Judicial Review and Merit Appeal processes, and consider that this counts against advancing the timeline for completion of the review. We consider that it would be desirable to gain greater experience with the operation of Part 4 before decisions on any substantive amendment of the IMs is made.

This notwithstanding, we appreciate the Commission's early engagement with stakeholders on the IMs review, prior to the commencement of work on the review.

We refer the Commission to the section on Post-Reset Priority Work Areas, in our 2015 DPP reset submission¹, as a starting point for consideration of potential IM review, and other priorities.

We are pleased that the Commission's operation of Part 4 is evolving, and there is an acknowledgement that there is further scope for improvement. Our comments are focussed on areas where we consider improvements can be made to the operation of price control/DPP resets to better promote the long-term interests of consumers. The areas we identify are wider than just the IMs (though that may depend on future decisions about whether to widen the scope of the IMs), as not all aspects of the operation of Part 4 fit within the IMs.

3 Timing

The Commission has proposed to complete the review of IMs by December 2016, in order to be able to apply any resultant changes to the 2017 reset of the default price-quality paths for gas pipeline services.

Aurora does not support an accelerated review of IMs.

¹ Aurora Energy. Submission Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015 and Low Cost Forecasting Approaches for Default Price-Quality Paths. 15 August 2015, section 14.

The cross-sector nature of IMs, and their application to both DPPs and CPPs, means that the timing of any IM review is unlikely to suit all regulatory decisions that the Commission is required to make. In our view, a principled stance would see the Commission weigh the materiality of the timing impact of the review on the various sectors.

Given the recent DPP determination for electricity distribution services, it is not unreasonable to expect that a number of Electricity Distribution Businesses (EDBs) may be considering whether or not to make CPP applications, including weighing alternative options for maintaining adequate profitability over the looming regulatory control period.

Advancing the review of IMs will create an elevated level of uncertainty for EDBs considering CPP applications, as it will not be immediately clear as to the rules under which the CPP must be prepared and submitted.

4 Guiding Principles

Aurora considers that there are fundamental principles that should underpin the IM review:

- Cross-sector consistency
- Reasonable investor expectations
- Predictability

4.1 Cross-sector Consistency

We agree with the Commission that it is generally desirable to take a cross-sector approach to reviewing IMs². We consider that the desirability of a cross-sectorial approach is wider than just for the IMs and Part 4 of the Commerce Act, though. For example, submissions from Chorus, and its experts on WACC, as part of the Part 2 Telecommunications Act unbundled copper local loop (UCLL) and unbundled bitstream access (UBA) final pricing principle (FPP) determinations may, if accepted by the Commission, have implications for the setting of WACC and other parameters under the IMs³.

4.2 Reasonable Investor Expectations

We discussed regulatory consistency, in relation to “reasonable investor expectations”, in our electricity DPP reset submission.

In the DPP reset submission we questioned how well some aspects of the proposals reflect “reasonable investor expectations”, and why the DPP reset consultation material made no reference to “reasonable investor expectations” even though the Commission used the principle repeatedly in its UBA and UCLL FPP consultation under Part 2 of the Telecommunications Act to justify judgements that would result in substantial uplifts in Chorus’ copper prices⁴.

The Commission appears to have addressed this apparent inconsistency by dropping the concept of “reasonable investor expectations” from its consideration of the UBA and UCLL FPP determinations.

We consider this to be a mistake.

² Commerce Commission. Open letter on our proposed scope, timing and focus for the review of input methodologies. 27 February 2015, paragraph 9.

³ For example, CEG has submitted why it considers the Commission was wrong to reject the Frontier-Dobbs modelling of the optimal WACC percentile, submitted by Transpower as part of the Part 4 WACC percentile review last year: <http://comcom.govt.nz/dmsdocument/13038>

⁴ Aurora Energy. Submission Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015 and Low Cost Forecasting Approaches for Default Price-Quality Paths. 15 August 2015, section 4.

The High Court's application of "reasonable investor expectations", in the Part 4 IM Merit Appeal decision, is appropriate for regulated sectors under Part 4 of the Commerce Act; i.e., regulated suppliers should expect to recover the costs of their prudent and efficient investments, and earn at least a normal return on that investment:

"In our view, reasonable investor expectations should be met by following a carefully considered approach when setting a RAB, subject to there being no evidence that suppliers would be unable to recover the costs of their past prudent and efficient investments. (This does not imply that the cost of purchase of a regulated business as a going concern should necessarily be fully protected.)." [emphasis added]⁵

In our view, we consider that any review of IMs should contemplate the degree to which they meet or facilitate "reasonable investor expectations".

4.3 Predictability

Regardless of the Commission's application of "reasonable investor expectations", we consider the Commission's position on predictability, as reflected in its 2 December 2014 draft determinations for the UCLL and UBA FPPs, to be equally (or, more, given the Commerce Act's IM objective of "certainty") applicable to Part 4 of the Commerce Act and the IMs; e.g.:

*"... we expressed our preference to emphasise predictability and efficient investment as objectives ..."*⁶

*"We consider that we should give weight to choices that provide greater regulatory predictability ..."*⁷

*"A lack of predictability can also affect confidence and investment incentives more broadly, not just those of regulated firms."*⁸

*"Giving effect to regulatory predictability is likely to give effect to the section 18 purpose statement ..."*⁹

It may well be productive to revisit what is included/not included in the IMs to determine whether they should be expanded; particularly given that the Commission appears to place greater emphasis on predictability now, as evidenced by the commentary in the Chorus' FPP copper pricing draft determinations, than it previously had within the Part 4 Commerce Act setting, where there was more of an emphasis on a perceived trade-off between certainty and flexibility, coupled with a presumption that certainty would emerge over time.

We consider that the frequent review, adjustment and development of IMs, since their promulgation in 2010, has done little to aid predictability or regulatory certainty for investors.

5 Specific priority areas for review

There are a number of specific matters we consider should be prioritised as part of the IM review and preparation for the 2020 resets more generally.

⁵ Wellington International Airport and others v Commerce Commission [2013] NZHC 3289, paragraph [605].

⁶ Commerce Commission. Draft determination. Draft pricing review determination for Chorus' unbundled copper local loop service. 2 December 2014, paragraph 126.

⁷ Commerce Commission. Draft determination. Draft pricing review determination for Chorus' unbundled copper local loop service. 2 December 2014, paragraph 126.1.

⁸ Commerce Commission. Draft determination. Draft pricing review determination for Chorus' unbundled copper local loop service. 2 December 2014, paragraph 130.

⁹ Commerce Commission. Draft determination. Draft pricing review determination for Chorus' unbundled copper local loop service. 2 December 2014, paragraph 184.

5.1 Related Party Transactions

The Commission has legitimate grounds to ensure that related party transactions occur under arms-length arrangements, and do not result in over-statement of EDB costs/understatement of EDB profits.

This is a complex area to get right. It isn't something that is unique to regulatory authorities. It is a vexing area for tax departments, particularly in relation to multi-national corporations.

The concern we have with the current related party arrangements is that they act too rigidly to avoid over-payment by EDBs for related party transactions, and this can give rise to the opposite problem.

This is highlighted by the difference between valuation at group consolidated cost (IMs 2.2.11 (5)(g)), and market value (IMs 2.2.11 (5)(f)).

By way of example, take a comparison of nine distribution projects, comprising a mix of asset relocations, undergrounding, feeder refurbishment, and bulk pole replacements.

The comparison highlights that valuation at group consolidated cost resulted in a valuation that was approximately 21% lower than market valuation. Whilst the Commission allows valuations to be "updated" following market valuation, the implication for EDBs is that they must bear this reduced value for many years, owing to the fact that market valuations take time to complete, and the resource pool for undertaking them is quite small. The knock-on effect is that capital allowances at the reset are likely to be understated, since the allowance is pegged against historical out-turn.

Market Valuation	\$ 5,739,433.00
Group Consolidated Cost	\$ 4,511,167.17
Difference \$	\$ 1,228,265.83
Difference %	21%

5.2 Emerging Technologies

The distribution industry, at an international level, is predicting significant disruption from emerging technologies, and refinement of existing technologies. As an example, increasing deployment of small-scale distributed generation, coupled with falling storage costs, is anticipated to increasingly disrupt traditional electricity distribution. While the pace of this change is currently uncertain, there appears to be support for the notion that once a certain tipping point has been reached (for example, low battery costs), deployment will increase exponentially.

What this means, in the context of Part 4, is a substantial increase in competition over time.

In our view, just as EDBs are turning their minds to how to cope with this change, the Commission must also give thought to how the Part 4 regulatory framework, including IMs, might react to a rapid increase in competition within a regulated market.