



MAJOR ELECTRICITY USERS' GROUP

19th August 2015

Keston Ruxton
Manager, Market Assessment and Dairy
Regulation Branch
Commerce Commission
By email to im.review@comcom.govt.nz

Dear Keston

Submission on Input Methodologies review – Invitation to contribute to problem definition

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission consultation paper¹ "Input Methodologies review – Invitation to contribute to problem definition" dated 16th June 2015. This is the "IM problem definition consultation paper". Attached to this letter and to be read as part of MEUG submissions are two independent expert reports:
 - New Zealand Institute of Economic Research report to MEUG, Commission review of the IM's – Identifying problems with current IM's, August 2015 (the "NZIER report"); and
 - Ireland, Wallace & Associates Limited report to MEUG, IM Review – "Black's Simple Discounting Rule" as a potential cross check on the IM cost of capital, 19th August 2015 (the "IWA report").
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. The NZIER report considers the broader industry context within which improvements to the IM are to be decided. That context starts with an environmental scan of factors such as emerging technologies, changing demand patterns and likely scope for productivity improvements in the provision of regulated line services. By taking a top down approach NZIER arrive at a view of problem definitions some of which align with problems squarely in the remit of the IM review and others that are not. We asked NZIER to consider an integrated top down approach because what matters is to focus resources on opportunities for greatest overall gain. MEUG wants holistic solutions that will be welfare maximising than, for example, deciding a solution for an IM problem in isolation.

¹ Document URL <http://www.comcom.govt.nz/dmsdocument/13312> at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>

4. The NZIER report attached continues the commentary of NZIER in their report attached to MEUG's submission on comments on scope, timing and focus for the review of IM both dated 20th March 2015. In that prior NZIER report they expressed the view that (paragraph 16) a range of external environment factors could be "... regarded as potentially the most profound changes to the energy industries since the initial development of the networks."
5. The IWA report is an analysis to demonstrate how the Black's simple discount rule can be used as a potential cross-check of price control regulation.
6. This submission first has comments on topics 1, 2, 3, 4, 5, 8 and 9 of the problem definition consultation paper². Second a discussion on ranking identified problems. The submission concludes with observations on the process to date and process going forward.

Topic 1: Risk allocation mechanisms under price-quality paths

7. This topic is an overview and introduction³ to topics 2, 3 and 4. No problems were suggested in the IM problem definition consultation paper.
8. Paragraph 133 invited submissions on how the package of mechanisms used in the current framework allocate and compensate risks between consumers and suppliers. From the problem definition consultation paper and the Commission staff presentations at the forum we have gained the impression that the various IM set in 2010 need to be viewed as a package and any proposed changes also need to be considered in terms of effects on other parts of the package. That balanced approach is also our expectation with a preference for quantitative weighing of any shifts in risk allocation before relying on qualitative arguments.
9. The title of this topic perhaps focuses too much on who will bear what risks. Any consideration of risk should think about who might be best incentivised to uncover productivity gains and innovate. Allocation of risks and rewards go hand in hand.

Topic 2: The form of control for price-quality regulated sectors

10. MEUG feedback of 20th March 2015 on the Commerce Commission open letter on scope, timing and focus of 27th February 2015 agreed this should be a possible topic. MEUG agree there may be a problem and this should be considered. That is not to say we agree there is a problem; rather further investigation is warranted to consider if this topic should be short-listed.
11. There is some overseas experience on this though, as emerged at the IM review forum, taking learning's from overseas jurisdictions is fraught with problems because the total regulatory package will be different and it's only within the context of the specific regulatory package can qualified views be made on price versus revenue control.
12. To decide if the form of control should be short-listed an estimation of the incidence and materiality of risks/detriments and incentives/rewards on distributors and consumers due to within in period demand risk (paragraph 175.1) should be considered. Two other factors should also be considered. First a shift in risk should be reflected in an adjustment elsewhere to retain balance in the overall scheme. Otherwise the proposal from suppliers could be simply "cherry picking". Second other solutions should be considered such as affected distributors having the option of seeking a CPP.
13. MEUG suggest the potential problem of incentives to invest in energy efficiency and demand side initiatives (paragraph 175.2) requires a whole of systems analysis approach using the type of framework proposed by NZIER.

² These are the topics listed in IM problem definition consultation paper, eg Table X1, p7. This submission by MEUG does not cover topics 6 and 7 because those relate to sector specific aspects for economic regulation of airports.

³ Refer IM problem definition consultation paper, paragraph 62.

Topic 3: Interactions between the DPP and CPP

14. The potential problem of the WACC for CPP applications misaligning with the current WACC for DPP is now being considered in a fast track process.

Topic 4: The future impact of emerging technologies in the energy sector

15. This topic and how suitable problem definition(s) might be developed are discussed in the NZIER report.
16. As NZIER note internationally this is one of two topics stretching regulators world-wide. The other, climate change externalities, is fortunately in New Zealand priced exogenously from the rest of the policy settings in the energy market. The risks and opportunities of emerging technologies is a factor the Commerce Commission and Electricity Authority must consider. In some scenarios the materiality of the issue at stake is very large; for example wide spread stranding of assets built to provide no longer needed regulated line services. The Deputy Prime Minister, Hon Bill English, referred to the riskiness facing distributors in his opening address of the Commerce Commission conference in July 2015.

Topic 5: Issues raised by the High Court on cost of capital

17. The Commerce Commission open letter on scope, timing and focus of 27th February 2015 listed a number of problems identified by the High Court. MEUG feedback of 20th March 2015 agreed those were problem areas and also suggested (p5) "another broad topic is to consider additional cross-checks and or complements to use of CAPM". We provided more detail on a possible cross-check approach on 7th July 2015 and again on 10th July 2015 in relation to Blacks discounting rule as applied by Claudio F. Loderer, John B. Long, and Lokas Roth in August 2008 and last revised in 2013.
18. The value of a cross-check, such as using Blacks discounting rule, is that there are well known problems in implementing CAPM. An article⁴ in the Journal of Applied Corporate Finance in 2010 eloquently summarised "the major challenges in applying the CAPM" and why as an alternative "Black's rule is elegant and simple." The critique of contents at the beginning of the Journal introduced the article as follows⁵:

"Corporate managers typically estimate the value of capital projects by discounting the project's expected future net cash flows at the cost of capital. The capital asset pricing model (CAPM) is generally used to estimate that cost. But, as anyone who has worked on the finance or business development staff of a public company can attest, there are major challenges in applying the CAPM, including largely unresolved questions about what constitutes the 'market portfolio,' how to estimate market risk premiums, and how to estimate the betas of projects."

19. MEUG asked IWA to demonstrate how the Black's simple discount rule can be used as a potential cross-check of price control regulation. The Journal article notes⁶:

"The virtue of Black's rule is that it shifts the focus of the analyst away from the assessment of discount factors and puts it squarely on the more challenging, and arguably more relevant, problem of estimating the project's cash flows."

⁴ Journal of Applied Corporate Finance, Volume 22, Number 2, Spring 2010, pp 60-68

⁵ Ibid, p5

⁶ Ibid, p60

20. In the IWA report, sections 4 and 5 and appendices B,C and D are explanations of assumptions and examples of how a line-item analysis could be undertaken for Transpower using the 2015-20 IPP. That analysis aligns with our intuition that Transpower's cash flows have very little risk relative to the risk free rate.

Topic 8: Cost-effectiveness of the rules and processes for CPP applications

21. The potential problem of the rules and process for CPP applications being a barrier to EDB making applications to the detriment of the long-term benefit of consumers is now being considered in a fast track process.

Topic 9: Reducing complexity and compliance costs

22. MEUG agrees there may be problems to be considered under this topic though they are likely to be less material than problems with the cost of capital IM or problems related to emerging technologies.
23. The IM problem definition consultation paper discusses (paragraph 480 to 483) cost allocation. MEUG feedback of 20th March 2015 on the Commerce Commission open letter on scope, timing and focus of 27th February 2015 also suggested (refer appendix p5) this should be a possible topic. There may be a problem that some of the cost allocation IM is overly complex as suggested by some suppliers. It's more likely more complexity will be needed to managing possible anti-competitive behaviour or dual till type opportunities arising from emerging technologies creating new markets for alternatives to distribution line services.
24. Cost allocation based on the capital investment employed may not reflect Board and senior management time on building non-regulated businesses as a result of emerging technologies. MEUG also believes the ex post financial reporting of regulated and non-regulated businesses is opaque and not conducive to consumers being able to reasonably assess the effectiveness of the Part 4 regime. This problem and the uncertainty of whether there is a material transfer of risk to the regulated business will increase as distributors diversify into unregulated businesses.

Ranking identified problems

25. Once the Commission has a list of possible problem definitions we suggest those be ranked in terms of the expected effect on the long term benefit of consumers. Top of the list must be problems with cost of capital because, for example, there is still a problem in understanding why Transpower and distributors have a WACC set at the 67th rather than 50th percentile when we know the capital investment needs are not increasing. The difference between the 50th and 67th percentile has a value to consumers of approximately \$80m per annum in charges. This WACC percentile example is illustrative of the high value of problems with the cost of capital IM.

Observations on the process

26. MEUG remains of the view that the decision by the Commerce Commission to undertake the review of most IM earlier rather than at the last required date was correct.
27. The concurrent consultation by the Commission on the problem definition consultation paper and the Electricity Authority on the Transmission Pricing Methodology options working paper has proven difficult for MEUG members, MEUG and probably other consumers and interested parties to effectively participate in both. The Commission and Authority have indicated 2016Q1 and Q2 as likely next major consultation phases. MEUG suggest the Commission and Authority plan their respective consultations to minimise overlap and therefore improve the ability of interested parties to participate.

28. As MEUG has noted at various times⁷ there are serious resource asymmetries between the monopolies and consumers. Overlapping major consultations by the two regulators doesn't help.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. Matthes', with a long horizontal stroke extending to the right.

Ralph Matthes
Executive Director

⁷ For example refer MEUG to Commerce Commission , 20th March 2015, paragraph 9 b)