



MAJOR ELECTRICITY USERS' GROUP

18th August 2016

Keston Ruxton
Manager, IM Review
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Keston

First cross-submission on Input methodologies draft review decisions

1. This is the first cross-submission by the Major Electricity Users' Group (MEUG) on the submissions of 34 other parties that closed 4th August 2016 on the Commerce Commission's draft Input Methodologies (IM) review decisions published 16th June 2016 and related materials.¹ A second cross-submission will be made on Topic 3: cost of capital next week.
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. Attached and to be read as part of this submission is a report by Mike Hensen of the New Zealand Institute of Economic Research (NZIER), Form of control for EDB – cross submission advice, 18th August 2016.
4. This cross-submission has 7 sections:
 - a) Weighted average price cap remains preferable to pure revenue cap for EDB;
 - b) Accelerated depreciation option for EDB remains an unsupportable proposal;
 - c) MEUG's concerns about lack of clarity on risk allocation supported by EDB;
 - d) MEUG's proposed re-fresh of Part 4 in light of views of other submitters;
 - e) Comments on submitters views on consumer participation;
 - f) Cost Allocation IM and emerging technologies; and
 - g) Concluding comments.

¹ Refer <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>

Weighted average price cap remains preferable to pure revenue cap for EDB

5. MEUG's submission of 4th August stated "... we do not believe changing from WAPC for EDB to revenue cap is in the best long term interest of consumers."²
6. The submissions of other parties were split between EDB/ENA agreeing with the draft IM decision to change to revenue cap (with various additional features proposed by different EDB) and network customers (retailers, Electricity Retailers Association of New Zealand (ERANZ) and MEUG) opposing the change.
7. We cannot overstate the importance of decisions on form of control as a factor for facilitating development of economically efficient distribution prices over the next 5 years. Hence, MEUG asked NZIER to consider the submissions of other parties and prepare a third report on form of control. The first NZIER report in March 2016 was a response to the Commission's emerging views on form of control and the second formed part of the MEUG submission on the draft IM review decisions lodged 4th August 2016.
8. Attached and to be read as part of this submission is the report by NZIER. The analysis by NZIER re-affirms our view that changing from WAPC for EDB to revenue cap is not in the best long term interest of consumers.

Accelerated depreciation option for EDB remains an unsupportable proposal

9. MEUG's submission of 4th August did not support the option of accelerated depreciation.
10. If as the Commission suggest there is no imminent problem then no action is needed. We agree with the view of the ERANZ "To use the Commission's own logic, it seems that the Commission is proposing certain higher costs on consumers as a result of shortened asset lives in response to an uncertain future risk."³
11. On the other hand if there is an imminent problem or in the longer-term there is a high probability that issue will materialise then is the proposed accelerated depreciation the best near term solution? The views of submitters included -

- a) The draft decision proposal on its own is counter-intuitive to what would happen in a workably competitive market for example by increasing prices⁴:

Contact Energy: "The proposal to shorten asset lives will raise distribution prices in the short term, resulting in current consumers bearing an increased cost which is unjustified."⁵ Later in Contact's submission "The granting of an 'option' for EDBs to apply for accelerated depreciation is not an NPV neutral decision. Options are of value to the party that holds them, and a cost to those consumers who bear the potential impact of them" and "Accelerating depreciation reduces the length of time for the recovery of capital, which in turn reduces exposure to future market, economic, technology and regulation changes. This reduction in risk for EDBs is not "NPV neutral" and has been seen as value positive by investors in EDBs."⁶

ERANZ: "Furthermore, the proposal the Commission has made will result in higher prices in the near term. This would seem to exacerbate the risk of standing (economic or otherwise) by bringing forward the point of economic parity. This is contrary to the behaviour that would be expected in a competitive market, where a competitive firm would likely reduce prices to maintain market share."⁷

² MEUG, paragraph 13.

³ ERANZ, paragraph 153.

⁴ This was also MEUG's view, paragraph 19 c).

⁵ Contact Energy, p2.

⁶ Ibid, p8.

⁷ ERANZ, paragraph 152.

- b) MEUG submitted that the proposal would likely be seen as, and probably would become, the thin end of a wedge by EDB to further shift risk onto consumers leading to accelerated (and inefficient) avoidance of network services by consumers.⁸

EDB that submitted on the proposal and ENA suggested it did not go far enough and suggested various additional features that would further shift risk onto consumers.⁹ This supports our view such a change would become a wedge EDB and ENA would seek to lever further concessions on this proposal should it be adopted. EDB would want to shift from 15% towards 100% accelerated depreciation on the expectation that the Commission's rationale for using 15% as a precautionary tool for an undefined risk would also justify higher and higher rates of accelerated depreciation as the risk become certain and escalated.

- c) MEUG has submitted that this topic should be considered as part of a broader view on how regulated services can exit regulation.¹⁰

Best regulatory practice involves an assessment of all feasible options to solve a pre-defined policy problem.¹¹ In the view of MEUG it doesn't matter whether the policy problem is real or only a possibility – in both cases all feasible options should be considered. What also matters, be it real problems evident now or possible problems likely to emerge in the long-term, is whatever solution is implemented now and in the near term is consistent with the long term direction of "travel".¹²

There is a risk that the proposals implemented lead us away from, or take longer and a more costly route to reach the best possible future. For example in the submission of Unison attempting to head-off any consideration of optimisation of RAB as a possible solution:

"For example, if emerging technologies do allow a number of consumers to reduce their reliance on the grid, such that there is partial asset stranding, it is easy to envisage that the Commission will come under pressure to re-introduce "optimisation" or "EV" tests as occurred under the old ODV rules, with EDBs asked to wear uncompensated write-downs of their assets. Application of the economic principles as forming a regulatory compact would dictate that the Commission would reject such pressure, whereas if the Commission considers it is not constrained by the principles and must focus on the long-term interests of consumers from that point in time, then under the Commission's logic it would potentially succumb to the pressure."¹³

EDB may wish that "optimisation" or "EV" tests not be part of the regulatory tool-kit in the future but the decision of whether to use those approaches must be considered on their merits at each future decision point and should have been considered in the current IM review.

12. MEUG's view remains unchanged that the accelerated depreciation option is unnecessary or indeed not supportable in this IM review.

⁸ MEUG, paragraph 19 b).

⁹ For example Unison, paragraph 13 states "... there is sufficient justification to universally provide for accelerated depreciation from 2020".

¹⁰ MEUG paragraph 10.

¹¹ For example see The NZ Treasury's, Guide to Social Cost Benefit Analysis, July 2015, paragraph 10, "... it is good practice to consider several alternative options for solving a problem or achieving an objective. Each of these should be treated as a separate policy to be evaluated against the counterfactual.", URL

<http://www.treasury.govt.nz/publications/guidance/planning/costbenefitanalysis/guide/cba-guide-jul15.pdf> at <http://www.treasury.govt.nz/publications/guidance/planning/costbenefitanalysis/guide>.

¹² MEUG, paragraph 10.

¹³ Unison, paragraph 39.

MEUG's concerns about lack of clarity on risk allocation supported by EDB

13. MEUG submitted the Commission “could assist interested parties by describing the risk allocated to suppliers and customers in a summary table. It should also provide narrative on the reasons one or both parties are best placed to manage or share risk. This is key economic Principle 2.”¹⁴ We suggested the Commission similarly be clear on risk allocation underlying the asset beta in the IM.¹⁵ These submissions arose from the analysis by Ireland, Wallace & Associates (IWA) for MEUG on the Commissions Framework for the IM review paper.
14. Several EDB raised concerns about how regulations may change in the future. Whereas MEUG is seeking clarity from the Commission so that all parties understand the line by line allocation of risks and trade-offs underpinning the total package and reconciliation with the systematic risk component of the IM asset beta, the focus of ENA and the EDB was to identify risks to their account and propose changes to the IM to shift those to consumers.
15. ENA and several EDB submitted that a “regulatory compact” or similar was needed to give the investors in their regulated services more certainty. We believe nothing in the submissions of ENA or the EDB justifies the Commission changing its view in the Framework paper that “We do not agree with submitters that these or any other economic principles amount to a regulatory compact.” The Commission correctly, in our view, continued “The key economic principles are subordinate to s 52A and we can only apply them in so far as they assist us to give effect to s 52A. The principles are not an outcome we seek to give effect to in and of themselves; rather, the application of the principles is a means to an outcome – that outcome being promotion of the long-term benefit of consumers in accordance with s 52A.”¹⁶
16. Nevertheless the desire by EDB and ENA for a regulatory compact or certainty on how the regulations change is closely aligned with our concern on the uncertainty of how risks are currently allocated and how those might change over time as the sector and regulations may change.
17. The treatment of future uncertainties relating to investment and operating decisions consistent with the 67th percentile WACC in the IM to manage asymmetric risk is not clear. For example Unison state “We agree with the Commission’s analysis that it is better to err on the side of caution when considering impacts on investment incentives as consumers are likely to be more disadvantaged by prices that are insufficient to encourage investment.”¹⁷
18. MEUG note that if the 67th percentile WACC is doing what it’s supposed to do – that is mitigate under-investment by EDB - then there is no need to “err on the side of caution” when deciding any other IM. If Unison’s quote above is correct regarding the Commission’s analysis then consumers need to know when the Commission has erred on the side of caution (often referred to as “aiming-up” by overseas regulators) and which “risk” was affected.

¹⁴ MEUG paragraph 43 a) quoting from IWA report to MEUG.

¹⁵ Ibid, paragraph 43 b).

¹⁶ Commerce Commission, IM review draft decisions, Framework for the IM review, 16th June 2016, paragraph X20.

¹⁷ Unison, paragraph 37.

19. Another example of the need to understand how risk allocation might change with the draft decision was provided by Meridian Energy regarding the proposal that EDB could apply for accelerated depreciation to manage emerging technology risks - "... Meridian does not support the Commission's proposal to allow accelerated depreciation. As we have said, we do not believe EDBs face any real risk of economic stranding in the foreseeable future and therefore do not support a proposal which will raise costs to consumers in order to address this non real risk. We note that the Commission itself does not seem to consider that there is solid evidence of any risk to EDBs of partial capital recovery. To the extent that the Commission disagrees with this submission and proceeds to allow accelerated depreciation Meridian submits that there should be a reduction in WACC accordingly."¹⁸
20. MEUG continues to submit that a risk allocation "ledger" and explanatory notes by the Commission is needed for the IM package as a whole and in detail for the allocation of risk associated with the selected asset beta. We believe all parties in the supply chain including the Commission itself would benefit from listing and assigning all material risks as a cross-check on the total risk in the IM and the overall package.

MEUG's proposed re-refresh of Part 4 in light of views of other submitters

21. MEUG's submission of 4th August proposed a refresh of Part 4 and the regulatory framework.¹⁹
22. ERANZ noted: "ERANZ regards the extent to which divided accountabilities across the policy/regulatory spectrum could lead to sub-optimal outcomes as highly unsatisfactory. If the right steps cannot be partially or fully implemented as part of the input methodology review, then ERANZ believes that a more co-ordinated approach is required from the respective policy and regulatory bodies."²⁰
23. After suggesting a review ERANZ continues: "The timing of such a review should allow any recommendations to be put into effect in time for the next EDB price reset in 2020 at the absolute latest."
24. MEUG agrees with ERANZ and would:
 - a) Add the point by ERANZ about divided policy accountabilities to the list of reasons of why a review is needed. In this case ERANZ was discussing the interface between the Commission and the Electricity Authority. The MEUG submission of 4th August only discussed the interface between the Commission and MBIE.

We should also add that a MBIE activity that should be part of a review of Part 4 and the regulatory framework is MBIE's requirement to publish Electricity Demand and Generation Scenarios (EDGS).²¹
 - b) Revise our submission proposing a refresh in 2020, ie post the next DPP and IPP resets, and agree with ERANZ a refresh of Part 4 and changes implemented in time for the next electricity price-quality resets in 2020.

There are multiple material issues that may not be solved by the Commission in this IM review. Without a further review those IM will be used as the building blocks to set DPP for EDB and Transpower's IPP for 2020 to 2025. These issues include a solution for emerging technologies, how to treat stranding and the perennial question of the WACC percentile. There is too much at stake to allow IM decisions this year

¹⁸ Meridian Energy, p5.

¹⁹ MEUG, paragraphs 5 to 10.

²⁰ ERANZ, paragraphs 155 to 158.

²¹ MBIE has had the role of publishing EDGS since the Electricity Authority replaced the Electricity Commission on 1st November 2010. An EDGS has yet to be published, refer <http://www.mbie.govt.nz/info-services/sectors-industries/energy/energy-data-modelling/modelling/electricity-demand-and-generation-scenarios>

on those topics to govern investment and operating decisions across the supply chain including by consumers in a potentially fast changing sector over the next 9 years. Hence the DPP and IPP reset in 2020 should use the building blocks from IM revisions this year along with any further consideration of unfinished material issues to be reviewed in the next 2½ years ahead of final decisions being made on DPP and IPP mid-2019 onwards.

Comments on submitters views on consumer participation

25. MEUG's submission of 4th August proposed several possible improvements to the proposed consumer consultation processes required of CPP applicants.²²
26. PwC stated "We suggest that the consultation on alternatives should be focussed on the key reasons for a CPP proposal, as per the information required in response to Clause 5.4.2 Reasons for the proposal."²³ MEUG agrees. Clause 5.4.2 (a) says a CPP proposal must with respect to the rationale for seeking a CPP contain a "detailed description" and clauses 5.4.2 (b) "summary of the key evidence" supporting the proposal. MEUG suggests that information must be sufficiently fine grained (ie "detailed" and with supporting "evidence" as required by the IM) to enable understanding by all and any individual consumer of the price-quality trade-offs that directly and indirectly will affect line prices they pay in the future with the status quo DPP compared to the proposed CPP.
27. Major Gas Users group (MGUG) noted "... on a topic such as monopoly regulation engagement is inherently asymmetric because many diverse uncoordinated consumers are asked to compete with submissions against the concentrated interest of suppliers."²⁴ MEUG agrees. Later MGUG stated "In some cases the Commission has set up focussed dialogues with consumer groups, which has been helpful (we think for the Commission as well). We think this is beneficial. An ongoing dialogue with identified consumer groups on more focused topics may also assist in helping to build consumer capacity for future engagement." This submission by MGUG that a more focussed engagement by the Commission yields better outcomes for both consumers and the Commission is also likely if the CCP IM requirement for consumer consultation by a CPP applicant is more prescriptive as we submitted on 4th August.
28. Methanex in commenting on the gas transmission pricing principles in the IM suggested an additional clause "To the extent practicable, prices are set for individual customers that reflect the direct costs of the services provided to that customer, plus a reasonable allocation of shared costs."²⁵ While not specifically related to the consumer consultation requirements for CPP applicants we think it's important because Methanex suggest specifying "individual customers." This aligns with MEUG's submissions in relation to consumer consultation requirements. Forecasting average impacts across various classes of consumers are insufficient – what matters to an individual consumer is the impact on their household or business.

²² MEUG, paragraph 15.

²³ PwC, paragraph 35.

²⁴ MGUG, paragraph 9.

²⁵ Methanex, p5.

Cost Allocation IM and emerging technologies

29. MEUG's submission of 4th August supported tightening the thresholds as a minimum to ensure optimal investigation into the feasibility of, investment in and operation of emerging technologies across the entire supply chain and by consumers.²⁶
30. As expected several EDB, retailers, ENA and ERANZ submitted on this topic. MEUG has no view on various legal opinions on whether the Commission can as part of this IM review use other ring-fencing type approaches instead of the proposed adjustment to the cost allocation thresholds mechanisms. Which of these solutions are feasible and should be implemented depends on whether there is a problem and the scale and scope of the problem.
31. In MEUG's view the evidence in submissions of several parties supports the argument that the existing thresholds are inconsistent with achieving optimal outcomes for both the short-term and long-term benefit of consumers. For example:
- a) Contact Energy illustrate the magnitude of existing problems with the Cost Allocation IMs using load control being offered into the reserves market noting that "since 2009 EDBs have generated (and retained for shareholders) ~\$15m in unregulated revenue through offering load control through ripple control systems into reserves markets."²⁷ Contact continue "We see nothing preventing EDBs from treating batteries (and any other potential load control devices) in the same way as ripple control systems, resulting in regulated consumers paying higher prices than if batteries and demand response were provided by competitive market service providers."
 - b) Contact Energy illustrate how the existing ACAM thresholds would allow, for example, Vector to invest up to \$260m in batteries, Powerco up to \$130m and Orion up to \$100m.²⁸ Halving the ACAM thresholds as proposed in the draft IM presumably would halve these investment values but even then the regulatory advantage of investments in batteries by those companies will be significant. Contact Energy also note, using the Commission's own analysis, that changing the thresholds would only affect Counties Power.²⁹ The proposed changes to the level of and processes for EDB in certain cases deciding for themselves the ACAM thresholds therefore appear not to be proportionate to the problem.
 - c) Asplundh, a vegetation management service provider, when submitting on related party transactions noted "We have seen examples where we are 33% (or greater) more cost effective than the current internal contracting services". Asplundh also reported "... approximately 8 of 29 EDBs utilise external vegetation service providers, with only some of these applying competitive market tendering processes. The remainder of EDBs use in-house or internal contracting services to deliver vegetation management services."

MEUG suggests this evidence points to a more generic problem for a majority of EDB wishing to retain local control at the expense of lowest possible service cost delivery. This problem may apply to both managing existing functions such as vegetation management and EDB ambitions to expand service offerings involving emerging technologies.

²⁶ MEUG, paragraph 20.

²⁷ Contact Energy, p12.

²⁸ Ibid, p15.

²⁹ Ibid, p15.

32. After considering the submissions of other parties MEUG has not changed its view that the Cost Allocation IM needs tightening. We do now have an understanding of the materiality of the problem and therefore any tightening of the thresholds will need to be almost an order of magnitude more than that proposed in the draft decision.
33. Adjusting the thresholds in this review is only an interim solution. The problem of managing emerging technologies and the interface between regulated and non-regulated businesses including exit from the regulation can only be solved through a comprehensive review of Part 4 and the regulatory framework as discussed in paragraphs 21 to 24 above.

Concluding comments

34. We look forward to the Commission's announcement of next steps in early September and final decisions being announced before the end of the year.

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