Submission on starting price adjustments

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1 INTRODUCTION AND EXECUTIVE SUMMARY

1. This submission addresses the Commerce Commission's (Commission's) consultation paper "Starting Price Adjustments for Default Price-Quality Paths".

2. In this submission Unison makes the following key points:

   a) The Commission should adopt a refined conceptual framework for developing starting price adjustments; and

   b) The Commission's approach to establishing the procedures for making starting price adjustments is not robust. In this submission Unison establishes an analytical framework in which to evaluate options for making starting price adjustments. Unison has viewed the ENA submission on starting price adjustments and agrees with its key conclusions. In particular, the Commission has put significant effort into justifying its input methodology proposals, but has applied less rigour to considering starting price adjustments. This reinforces the need to include the starting price adjustment approach as an input methodology. We are particularly concerned by statements (e.g., paragraph 4.20) that the Commission may apply discretion to establishing key parameters, without setting out a framework for how such discretion would be exercised.

3. In this submission we have sought to provide constructive proposals as to how the Commission might proceed to continue to develop its approaches to starting price adjustments. We support the ENA's submission that the Commission should consult further with the industry on more comprehensively analysed options and data. We are concerned that the Commission tends to assert its approaches (e.g., the use of operating expenditure variability to proxy for ROI variability) rather than demonstrate that its approaches are the best of the options available.

4. Finally, Unison submits that the proposed approach to treatment of merger and acquisition costs and benefits remains inadequate in promoting merger/acquisition activity. We continue to support the ENA's submissions on input methodologies relevant to merger/acquisition gains.[1] In particular, a ten year period is required to promote mergers/acquisitions. The Commission's stylised picture of all costs being incurred at the beginning of a merger and all benefits being realised smoothly over time is unrealistic. The reality is that costs and benefits are realised progressively over time, and it may be difficult for businesses to separate out all merger related costs (for example, employees diverted from their ordinary work or working overtime to work on integration or a bid).

[1] ENA (2010) "Submission 5, Processes and Rules Input Methodology". 9 August 2010; ENA (2010) "Submission 10, Input Methodologies Draft Determinations Parts 1-4, Part 3 Subpart 4". 25 August 2010.

2 CONCEPTUAL FRAMEWORK FOR STARTING PRICE ADJUSTMENTS

2.1 Commission's proposals

5. The Commission proposes to make starting price adjustments under the following framework:

   a) The Commission will establish a point estimate of the WACC at the 75th percentile of the estimated WACC.

   b) It will then establish a band around the WACC to account for the fact that there is variability in returns such that there is not statistical confidence that recently reported returns are statistically distinct from the WACC.

   c) The Commission will "normalise" recently reported returns for "one-offs" to ensure that starting price adjustments are not based on anomalous data.

   d) The Commission will not take into account information in asset management plans to establish estimates of "projected profitability".

   e) Starting price adjustments will be made to those that exceed or are below the (symmetrical) band around WACC.

2.2 Unison's response

6. Unison agrees with the Commission that an approach is required to ensure that the low cost objectives of DPP/CPP regulation can be met, taking into account uncertainty about current and projected profitability. In particular, if the Commission was to make starting price adjustments so that expected returns are equated to the point estimate of WACC then there would be high probability that there would be an excessive number of CPP applications. This would occur for two reasons:

   a) Reported returns are subject to year on year variation, such that reliance on recently reported returns (even averaged over a few recent years) may provide a poor predictor of future profitability; and

   b) Future capital and operating expenditure requirements are not consistent with existing revenues/returns (i.e., returns would be eroded at current revenues as a result of higher future capital and operating expenditure).

7. In Unison's view the Commission has the wrong frame of reference. The Commission appears to be addressing the question of whether existing returns are statistically different to the 75th percentile WACC and therefore develops a proposal to adjust starting prices to the point at which the hypothesis that observed returns are equivalent to the WACC cannot be rejected.

8. Unison submits that the proper framework is to make starting price adjustments such that EDBs do not have to apply for CPPs unless there are abnormal circumstances

(e.g., a substantial increase in capital expenditure requirements above recent trends). Unison submits that EDBs should not implicitly be required to apply for CPPs to cater for normal cyclical investment patterns experienced by all businesses.

9. Unison submits that under the Commission's proposed approach (which requires symmetry in the band), there may be the following consequences:

   a) EDBs that fall below the lower band which, on an indicative basis will be below the 50th percentile, will face incentives to apply for a CPP if they consider that their performance is likely to be systematically below the 75th percentile, i.e., there are not short-term factors that have temporarily lowered reported returns. For some EDBs (e.g., Centralines) the costs of making a CPP application are likely to be substantial. It would be contrary to the interests of consumers of such EDBs to require EDBs to apply for a CPP just to obtain a reasonable return on existing investments; and

   b) By not taking into account any forward-looking information about each EDB's "projected profitability", the Commission risks requiring undue numbers of CPP applications for businesses that face growing capital and operating expenditure requirements on a business as usual basis. Hence, (under the Commission's primarily historically-based approach) the upper band on WACC would need not only to take into account some measure of variability in reported returns, but tolerances for business-as-usual cycles in operating and capital expenditure. For example, a business that currently reports an ROI consistent with the 75th percentile, but expects to incur higher operating and operating expenditure moving forward would be required to apply for a CPP to obtain satisfactory returns. Accordingly, it is essential for the Commission to consider forward-looking information on financial performance, or make allowance for not considering such information in setting the starting price adjustments.

10. Unison submits that in developing its starting price adjustment approach, the Commission must ensure that:

    a) The key relevant requirements of the section 52A Purpose Statement are met (in particular, EDBs face an effective return on investment that ensures they can at least provide a reasonable return to funding providers, and therefore have incentives to invest); and

    b) EDBs do not have to unnecessarily resort to making a CPP application for business-as-usual circumstances.

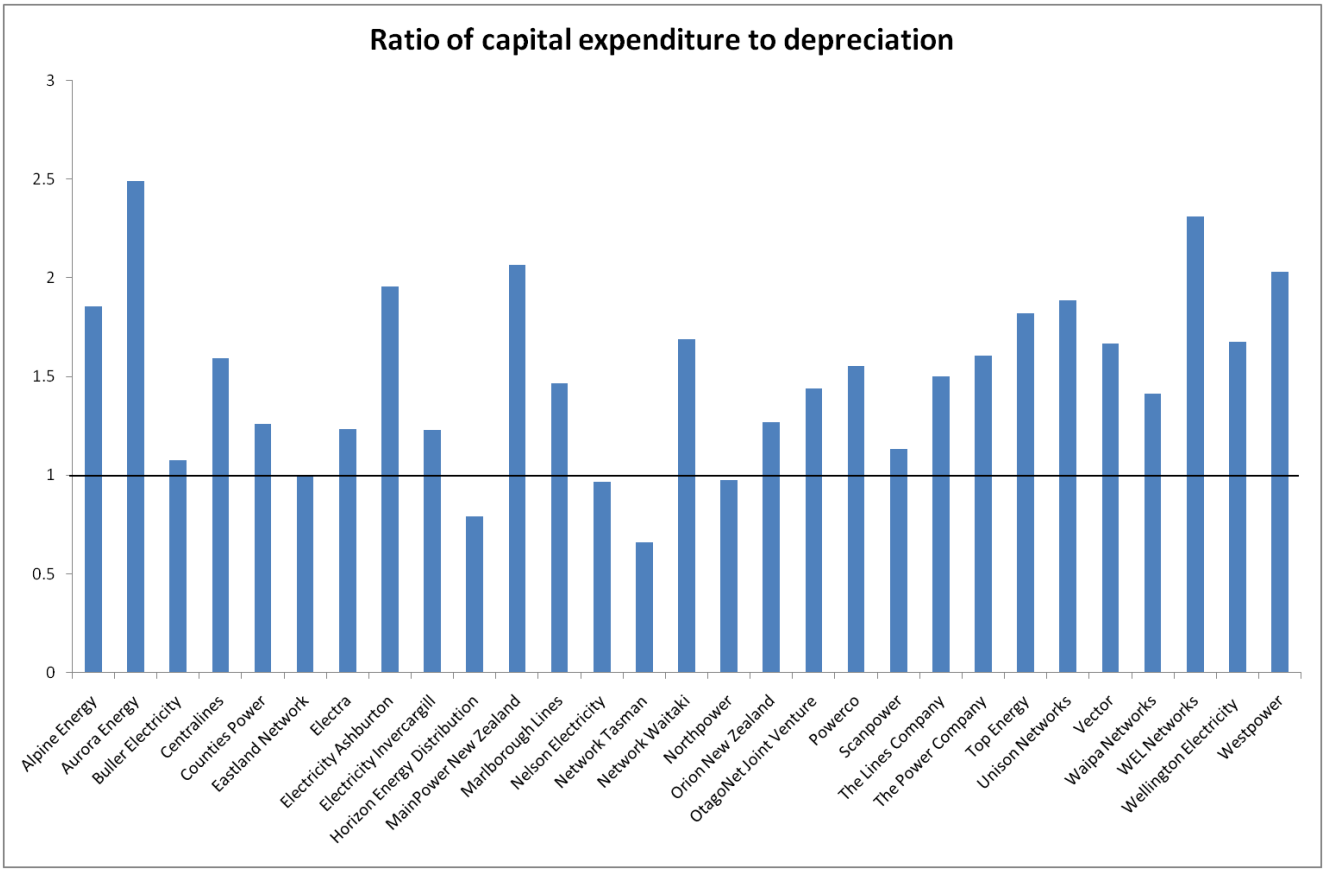
11. Unison submits that the Commission should adopt design criterion that focuses on ensuring EDBs have reasonable prospect of being able to achieve reasonable returns by complying with their DPP path, without undue recourse to applying for a CPP. This could potentially be achieved by the following criterion:

Set P_0 adjustment such that probability of application for CPP < μ, (where μ is some low probability that an EDB would need to apply for a CPP to achieve a reasonable return).

12. Such an approach would result in starting price adjustments bringing EDBs to a point estimate above the WACC. This is consistent with providing incentives to invest, and in ensuring EDBs have limited ability to earn excessive profits. The need to select a reference point above the point estimate of the WACC is necessary to ensure that there are not undue numbers of CPP applications, meeting the intent of the DPP/CPP regime to keep the costs of regulation low.

13. By providing a point estimate above the WACC any variability in ROIs (e.g., due to volatility in year-to-year revenues due to weather, economic variation) is able to be accommodated. Importantly this provides potential for EDBs to earn reasonable returns with business-as-usual cycles in capital and operating expenditures if the Commission continues with an approach which does not examine forward-looking information which impacts on projected profitability. The more the Commission constrains the information-set to be considered in making starting price adjustments, the greater is the required allowance to ensure businesses are not unduly required to make CPP applications.

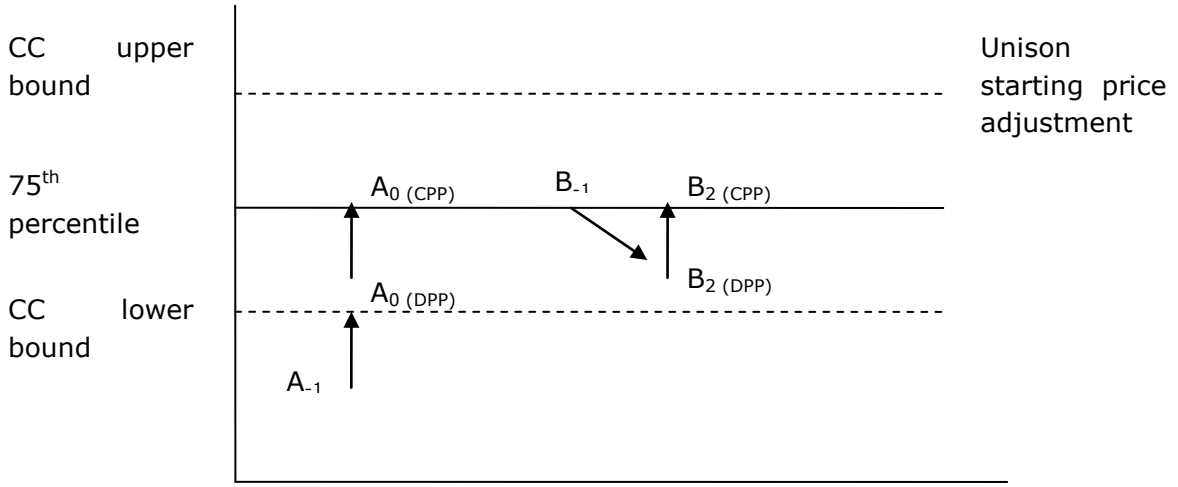
14. To illustrate these concerns, consider the following chart which demonstrates the ratio of EDBs' average capital expenditure to depreciation ratios for the past three years:



15. The chart illustrates that for a large number of EDBs there is a sizeable net increase in the RAB over time (in most cases as a result of renewal and replacement expenditure) which requires increasing revenues. Hence, there is no guarantee that those businesses within the Commission's indicative WACC band (and certainly below the 75th percentile) will be able to achieve reasonable returns under the DPP and therefore there is high likelihood of large numbers of CPP applications (or businesses being run down, if EDBs consider the CPP application process to risky).

16. In other words, there are a number of EDBs facing an increasing revenue requirement (even without taking into account capital expenditure plans). The Commission should not ignore such industry-wide feature in designing the starting price adjustment approach.

17. Unison's proposed approach is contrasted with the Commission's approach in the following diagram:



18. The diagram illustrates that based on data available at period -1 (i.e., one year prior to the reset) EDB A receives a P0 adjustment under the Commission's approach which moves the EDB to the lower bound return (marked A0 (DPP). EDB A will accordingly be forced to make a CPP application to achieve a 75th percentile return, in the event that there are not temporary factors that suppressed returns in year -1.

19. EDB B sits within the Commission's band in period -1, and receives no starting price adjustment. After two years EDB B's returns are below the 75th percentile because cost growth (most likely from capital expenditure in excess of depreciation) falls to below the 75th percentile. Again EDB B is forced to apply for a CPP in order to achieve a reasonable return. In this instance a CPP application is required because returns fall because of capital expenditure needs (but this could also arise in circumstances where measured returns in period -1 are temporarily high).

20. The key issue is that under the Commission's approach there is high probability of CPP applications because no tolerances are put in place (and the Commission proposes to only use historical information on ROIs).

21. Unison's proposal is that all EDBs have a P_0 adjustment to take them to a point estimate above the WACC (for convenience illustrated at the same level as the Commission's proposed upper bound). As set out above, this would:

    a) avoid unnecessary/undue CPP applications and ensure that the regime is kept low cost (section 53K). Only those EDBs that have unusually large capital expenditure requirements (above trend) would need to apply for a CPP;

    b) ensure EDBs are *limited* in their ability to earn excessive profits (section 52A(1)(d));

    c) create incentives for EDBs to invest, by ensuring that in most circumstances an EDB's DPP reset will allow them to earn at or above the cost of capital (section 52A(1)(d).

22. Unison submits that in designing the DPP/CPP regime to be low cost and in adopting the terminology in section 52A(1)(d) that regulated suppliers are only limited in their ability to earn excess profits, Parliament consciously was adopting an approach where EDBs would be able to earn somewhat above the point estimate of the WACC to ensure that most EDBs would be able to comply with their DPP.

2.3 Establishing a reasonable point estimate of returns for starting price adjustments

23. In this subsection we address the conceptual framework for developing a reasonable point estimate for making starting price adjustments.

24. It appears to Unison that there are two key choices available to the Commission in developing an approach to starting price adjustments:

    a) Base them only on historic information on returns; or

    b) Use a partial building blocks approach to forecast projected returns, again in conjunction with a band to take into account the less-than-full building blocks approach to estimating future financial performance.

25. The Commission discounts option b) on the basis that using information, such as from asset management plans ("AMPs"), risks relying on information that has not been subject to the same scrutiny as under a CPP proposal.

26. Unison considers that the Commission is too quick to draw such conclusions. Firstly, Directors must certify that the information in AMPs is that which is used by the business, and so the potential for any "gaming" of AMP information is reduced. Secondly, and more importantly, the Commission needs to consider the extent that inaccurate information in AMPs might impact on the accuracy of DPP resets, or alternative forward-looking approaches that might mitigate such concerns.

27. Unison submits that the Commission should undertake experiments using AMP information in a partial building blocks model to understand the effect of over-estimations of capital and operating expenditure. On preliminary analysis that Unison has undertaken, the cumulative effect of a 20% over-forecast of our projected capital expenditure per annum, would only result in around 0.1% difference to our returns by the end of a five year regulatory period. This is because capital expenditure over a short-time horizon of five years provides a smaller contribution to returns compared with returns from existing assets. Therefore a 20% inaccuracy in capital expenditure forecasts makes very little difference.

28. Alternatives also exist to AMP information. For example, as illustrated above, EDBs differ across the sector in the ratio of capital expenditure to depreciation. Some EDBs over the past three years have average ratios of capital expenditure to depreciation that exceed 200%, whereas others have more steady-state ratios where the RAB remains relatively static. Such ratios could be used to inform a partial building blocks analysis.

29. Unison's key point is that the Commission has only asserted that such partial building blocks approaches are not appropriate in making DPP reset starting price adjustments. This is manifestly inadequate for such an important aspect of the regime. Unison submits that the Commission must fully explore different possible approaches to undertaking partial building blocks approaches; as well as assess their likely predictive

power compared to the Commission's simple alternative of effectively assuming that all EDBs are in a steady-state when making starting price adjustments. As the comparison of capital expenditure and depreciation above illustrates, such an assumption is unlikely to hold in practice.

30. In respect of the Commission's proposals (at this stage) to use only variation in operating expenditure to proxy for ROI variability, Unison submits that the Commission must undertake more rigorous analysis of possible ROI proxies. The Commission has asserted that it can use variability in operating expenditure to proxy for variability in ROIs, on the basis that there is a 0.8 correlation in ***levels*** of operating expenditure and revenues. Unison does not understand why the Commission considers correlations between levels of operating expenditure and revenues is relevant. We consider that it should be correlations in real changes in revenues and operating costs that the Commission should be calculating. But even aside from this, ROIs will be driven by variability in the difference between revenues and operating costs, which fundamentally have different drivers, and always will. For example, asset age is a significant driver of maintenance costs: this has no relationship to the level of consumption, and therefore revenues.

31. The Commission states at paragraph 6.17 that it does not rely on variations in revenues as these are driven by "demand for electricity which is driven by generators, lines businesses and retailers and the Commission does not have sufficient information to disentangle these effects". The Commission does not elaborate on why this criteria is relevant to its analysis, but Unison submits that it will always be the case that revenues will be driven by factors external to distributors and this will be fundamental to understanding volatility in ROIs. It is not evident why it is so important to disentangle different effects.

32. While we appreciate that the Commission is seeking only to provide an indicative analysis of its approach, Unison is concerned that the Commission's discussion reveals a relatively haphazard approach to measuring variability in ROIs. It would be considerably more accurate for the Commission to measure variability in ROIs by using historic ROI information. Unison recognises that past disclosures are not based on a consistent approach or set of input methodologies. Accordingly, it will be necessary to obtain a normalised dataset of the components of past disclosed ROIs that will continue to be reflective of components of ROIs under the new Part 4 regime to measure variability. This should be the preferred approach, and the Commission should only resort to proxies for ROI volatility where the analysis proves intractable.

33. For example, historic ROIs could be normalised by removing the effects of past ODV revaluations (if there are not to be future ODV revaluations that would impact on ROI variability). In its place (or examined for its contribution to ROI variability separately) the Commission could substitute CPI variability. Similarly, in terms of obtaining a normalised revenue dataset, the Commission could deduct/add back revenues in excess/under the allowed price path reported in threshold compliance statements.

34. The key issue is that the Commission must apply rigorous analytical techniques to establish a reasonable means to estimate statistical variations in ROIs. Given the

importance of the DPP reset process to ensuring the Purpose of DPP/CPP regulation is met, this is a critical workstream.

35. Unison submits that the Commission should work closely with the industry in developing a better understanding of historical data and developing a normalised data-set on which it can make informed decisions about variability in returns. For example, we understand that PwC has an extensive dataset of historical disclosure information as well as a detailed understanding of the disclosure regimes and what lies behind reported information. We strongly urge the Commission to make use of such expertise, as it develops its further thinking on these issues.

3 CONCLUDING COMMENTS

36. The starting price adjustment approach, aside from core input methodologies such as RAB and WACC, is the most critical "input methodology"[2] facing EDBs. It is intended to form the basis for most regulated EDBs' price and quality paths for each regulatory period, and as such EDBs are seeking a high level of confidence and certainty from the approach. Given the costs and risks of a CPP approach, it is critical that the starting price adjustment approach is rigorously designed and durable.

37. It is not evident from the Commission's consultation paper what further data has been evaluated or what analysis has been carried out by the Commission in making its initial proposals. Unison submits that the Commission should engage further with the industry on what it has considered to date, so that we may consider engaging further expertise to assist in developing normalised datasets and robust (statistical) approaches to developing starting price adjustments.

[2] Whether or not the Commission wishes to accept it as an input methodology or not.