MAJOR ELECTRICITY USERS' GROUP

10 September 2010

Matthew Lewer
Regulation Branch
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Mr Lewer

Submission on starting price adjustments for Default Price-Quality Paths

1. This is s submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission discussion paper "Starting price adjustments for Default Price-Quality Paths" published 5th August 2010[1]. The discussion paper proposes resetting aggregate revenues for individual non-exempt Electricity Distribution Businesses (EDBs) at the start of the next Regulatory Control Period (RCP) based on an assessment of excessive profits (or not) up to year 4 of the current 5 year RCP[2]. The assessment of excessive profits (or not) compares the Input Methodology (IM) determined ex ante cost of capital (the "WACC") with actual Return on Investment (ROI). A dead band around the WACC will be set and revenue adjustments will only be made for ROI above or below the dead band.

2. Once aggregate revenues are reset (or stay the same if ROI within the WACC dead band) then the same "X" to reflect expected sector wide productivity gains is applied in the CPI-X formula for all EDBs subject to DPP. The aggregate revenue reset at the start of each RCP is therefore the primary opportunity under DPP to limit excessive profits and to allow consumers to share efficiency gains achieved by EDBs.

3. The generic nature of DPP may not suit some EDBs, for example because future capital expenditure and demand growth may materially affect future ROI compared to that assessed for DPP, and therefore EDB can seek a Customised Price-Quality Path (CPP). The discussion paper notes the Commission has changed its views on how to reset aggregate revenues. In general the DPP reset will use actual historic data to form a view on projected profitability rather than use Asset Management Plan and other forecast data. In essence DPP will use past trends to inform views on the future and CPP will give EDBs scope to argue more tailored regulation using better forecast cost information that the Commission can validate.

[1] http://www.comcom.govt.nz/2010-2015-default-price-quality-path/
[2] This is the generic approach for future resets. Because of delays in the initial reset, the timing will differ.

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4. This submission focuses on EDBs because MEUG understands the materiality, incentives and prior behaviour of those businesses. MEUG is unsure if the comments that follow would also apply to Gas Transmission Businesses (GTBs) and Gas Distribution Businesses (GDBs) because we are not as familiar with those sectors and in some cases price rather than aggregate revenue caps apply.

5. On the overall approach proposed MEUG note:

   a) There is a risk of a piece meal approach to deciding some aspects of the revenue reset process ahead of other parts. MEUG suggest affected parties, both suppliers and consumers, need to be aware of and understand how the entire regime fits together. For example in materiality is an important judgement in the following (not intended to be an exhaustive list):

      i) Normalising information to determine ROI;

      ii) Setting the dead band; and

      iii) Implementing claw back under s.54K (3).

      Defining materiality for each of these needs to be consistent and solved as a package not piece meal.

   b) The practical effect of the legislative prohibition on the Commission to use comparative benchmarking on efficiency to reset revenues for DPP are now becoming apparent[3]. This issue may merit a revision to the Act and hence how future DPP resets are conducted.

6. On the detail of the proposed approach MEUG note:

   a) MEUG has separately submitted on the IM for cost of capital and the lack of symmetry with the proposed Incremental Rolling Incentive Scheme. Those prior submissions still stand and the points we raised are not repeated in this submission.

   b) We disagree with the argument that there are two uncertainties[4] that justify a ROI dead band around WACC:

      i) The first claimed uncertainty is use of accounting information to calculate ROI is an imperfect proxy for a WACC equivalent. The discussion paper fails to consider what incentive and controls EDBs have to influence the acknowledged flexibility[5] to calculate ROI. EDBs have the incentive and ability to influence reported ROI and to that extent any uncertainty is likely to lead to reported ROI understating actual returns.

         Use of historic ROI data over several prior years will reduce the ability of EDB to manipulate the data and hence reduce this uncertainty.

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[3] Discussion paper, paragraph 3.16, bullet point three and footnote 32, and paragraph 3.17, bullet point three and footnote 33.
[4] Discussion paper, paragraph 4.17
[5] Ibid paragraph 4.17, bullet point 1, notes "*However, within these boundaries, suppliers have some flexibility as to how these statutory and regulatory accounting standards are interpreted and implemented in practice*."

ii) The second uncertainty is fluctuations in economic factors. The discussion paper discounts the risk of a step-change increase in asset replacement as being one of those factors[6]. MEUG does not know and the discussion paper does not list any other factor that could have an equivalent impact. In the absence of the Commission identifying and assessing the materiality of other factors, the rationale for having "uncertainty in fluctuations in economic factors" to justify a dead band is redundant.

MEUG therefore conclude there is no case for a dead band for the initial reset.

In addition MEUG suggest the static dead band example used in the discussion paper can only work if a single year of data is considered. We understand the proposal is to use ROI data for a number of years. We support this approach because it's the trend in actual ROI relative to WACC that are useful to take a view on future expected profitability. In using trend data over time we do not see how a dead band approach would work.

c) Expanding on the last point on using historic trend data:

i) If the historic ROI trend extrapolated into the next RCP will lead to ROI above WACC for that RCP, then aggregate revenues should be adjusted downwards; and

ii) If the historic ROI trend extrapolated into the next RCP will lead to ROI below WACC for that RCP, aggregate revenues should be adjusted upwards.

7. This submission is not confidential.

Yours sincerely

Ralph Matthes
Executive Director

[6] Ibid, paragraph 4.17, bullet point 2, referencing 2007 Farrier Swier study.