

Resetting the 2010-15 default price-quality path for 16 electricity distributors



Briefing for financial market analysts
30 November 2012

Overview

Today we published a final decision to reset the default price-quality paths for 16 electricity distribution businesses

- Context for decision
- Summary of our profitability assessment
- Key features of our final decision
- Conclusions

Final decision to reset prices

We have changed the default price-quality paths for 16 electricity distributors to better align their revenues with their costs:

- Our decision primarily affects the maximum average price that each distributor can charge between 1 April 2013 and 31 March 2015
- 'Claw-back' is allowed to correct for over- or under-recovery that occurred between 1 April 2012 and 31 March 2013

Final decision to reset prices

We have not reset Orion's default price-quality path:

- Orion is preparing a 'customised' price-quality path proposal
- We will review if Orion does not submit proposal in February 2013

Transition to new regime

This decision completes the transition to the new regulatory regime applying to electricity distribution services:

- On 30 November 2009, we set the 2010-15 default price-quality path by simply 'rolling over' the prices that previously applied
- At the time, we were still consulting on 'input methodologies' (key rules, requirements and processes)
- Prices could be reset once input methodologies were determined

Transition (cont)

- Input methodologies were originally determined in December 2010
- Our initial intention was to apply input methodologies in price-quality paths from 1 April 2012
- We published a draft decision in July 2011, but that draft decision was not finalised because of litigation

Transition (cont)

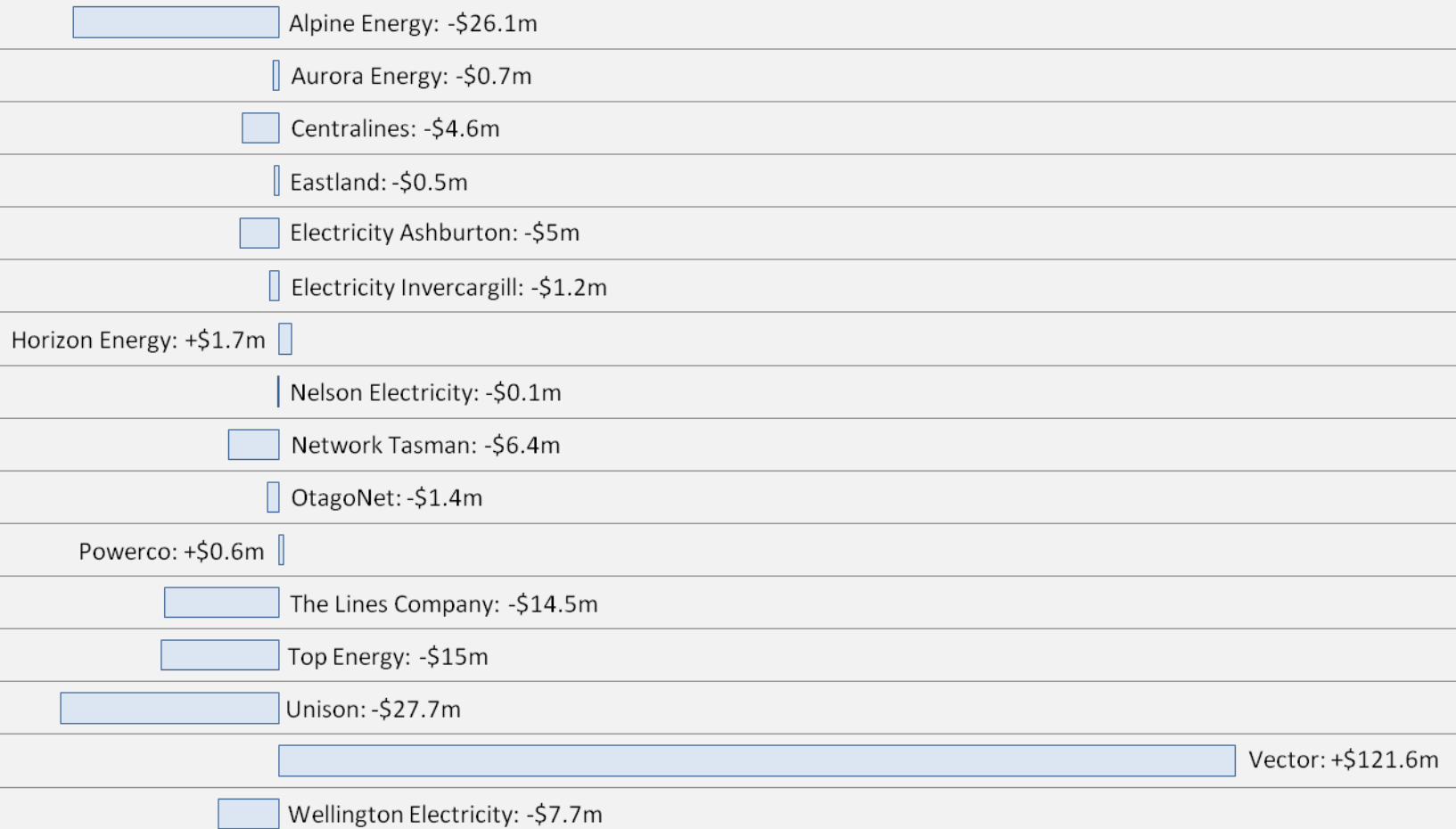
- The High Court required us to re-determine input methodologies for asset valuation, cost allocation and taxation so that these matters were specified as applicable to default price-quality paths
- On 30 September 2012 we re-determined the input methodologies
- The new paths reflect the impact of applying the input methodologies

Context for decision

Price paths are based on the current and projected profitability of each supplier:

- A revised draft decision was published in August 2012
- We have updated our approach in light of responses to that paper, as well as information provided by suppliers
- We have also applied the final input methodologies, which differ in some respects to the methodologies we applied in our revised draft decision

Realigning revenues with costs



Figures above are for the period 1 April 2012 to 31 March 2015 (earnings without reset)

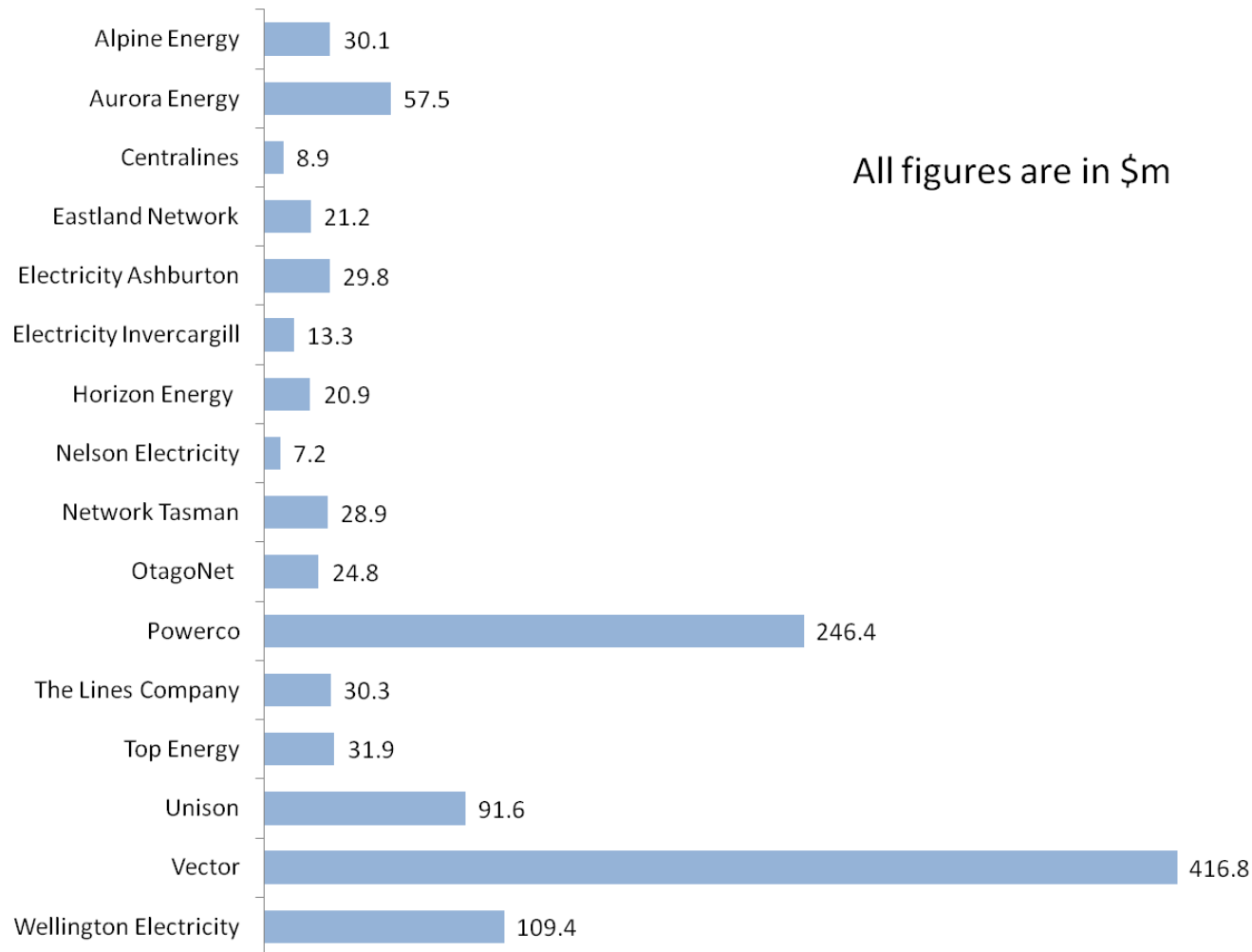


Key features

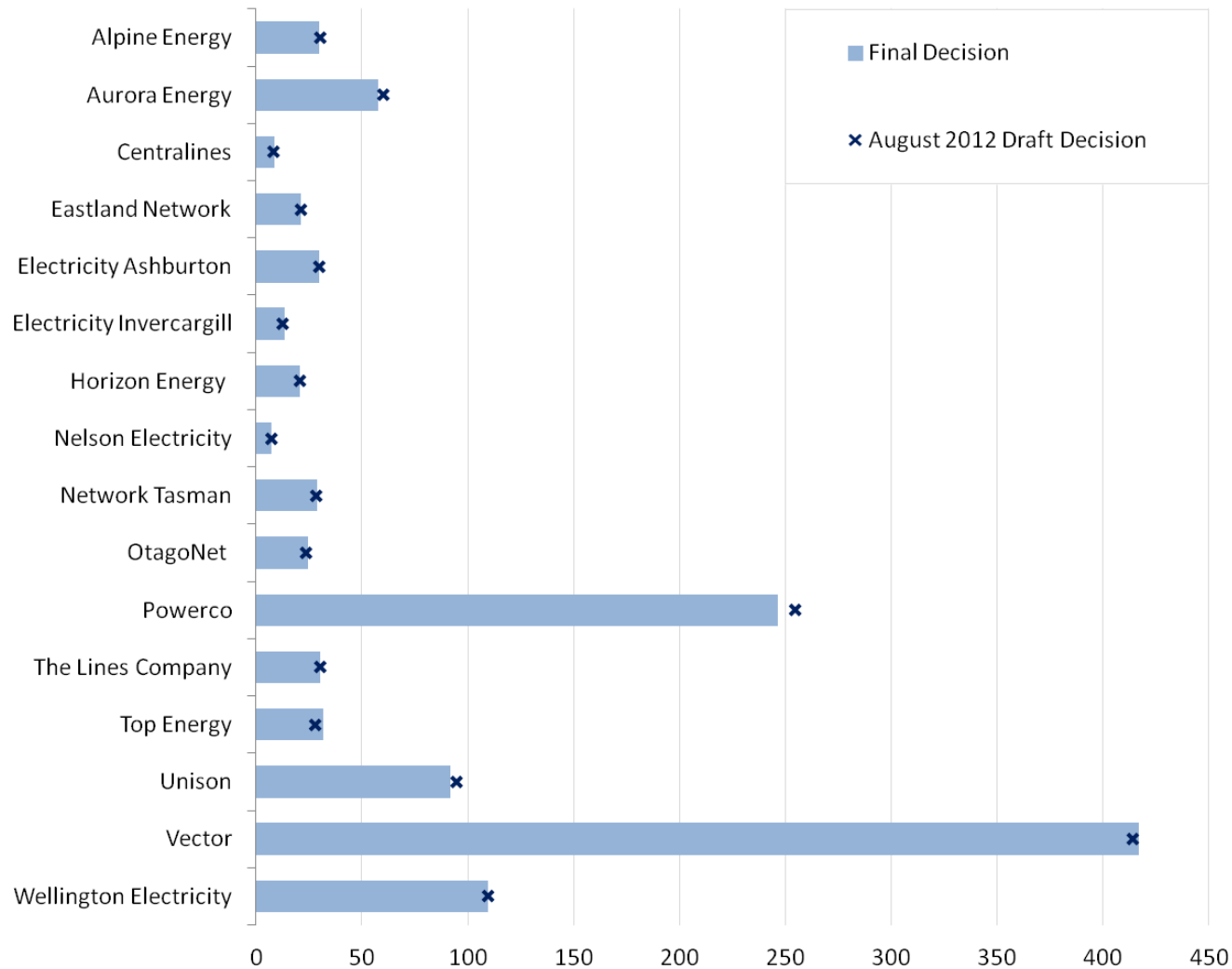
Our decision has three main features:

- The maximum revenue that each supplier can expect to recover through prices in 2013/14
- The rate of change in price allowed on 1 April 2014, prior to any claw-back amounts being applied
- The applicable amount of claw-back

Expected revenue in 2013/14



Changes since our draft decision



Price change allowed on 1 April 2014

The change in price allowed on 1 April 2014 (last year of regulatory period) depends on:

- The rate of change in price allowed prior to any claw-back amounts being applied
- The amount of any claw-back to be applied in 2014/15.

Allowable rate of change in price

Table 1 below shows the rates of change for each supplier on 1 April 2013 and 1 April 2014, prior to any claw-back amounts being applied.

**Rate of change in allowed price
(1 April 2013 to 1 April 2014)**

Electricity Distributor	August 2012 Draft Decision	Final decision
Alpine Energy	CPI+15%	CPI+10%
Aurora Energy	CPI-0%	CPI-0%
Centralines	CPI+15%	CPI+10%
Eastland	CPI-0%	CPI-0%
Electricity Ashburton	CPI-0%	CPI-0%
Electricity Invercargill	CPI-0%	CPI-0%
Horizon Energy	CPI-0%	CPI-0%
Nelson Electricity	CPI-0%	CPI-0%
Network Tasman	CPI-0%	CPI-0%
OtagoNet	CPI+11%	CPI-0%
Powerco	CPI-0%	CPI-0%
The Lines Company	CPI+15%	CPI+10%
Top Energy	CPI+15%	CPI+10%
Unison	CPI-0%	CPI+8%
Vector	CPI-0%	CPI-0%
Wellington Electricity	CPI-0%	CPI-0%

Claw-back from 1 April 2012

Claw-back will be applied to allow suppliers to earn a normal return from 1 April 2012:

- For most suppliers, the amount to be clawed back will be equal to any over- or under-recovery in the 2012/13 year
- Claw back helps to neutralise the impact of the delay to price reset
- The interest rate for calculating claw-back is the supplier cost of debt over the three year period 1 April 2012 to 31 March 2015 (5.84%)
 - Approximates the opportunity cost to suppliers and consumers

Claw-back from 1 April 2012

Application of claw-back:

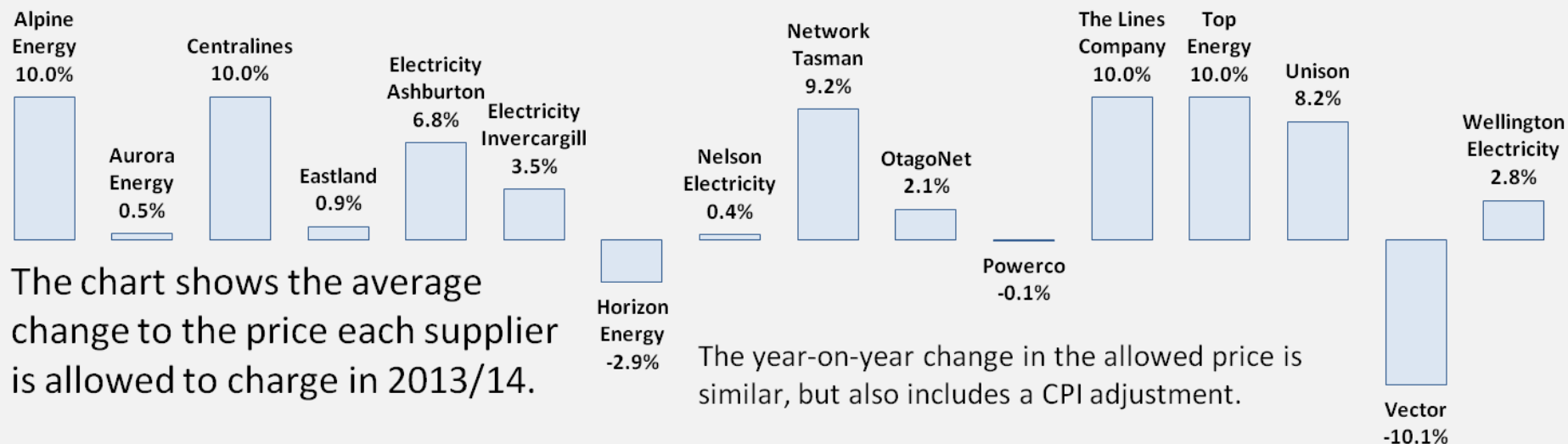
- Claw-back will generally be applied in full in 2014/15
- The exception is for the five suppliers already facing price increases on 1 April 2014 in excess of CPI+5%
- For these suppliers, claw-back will be deferred until the next regulatory period
- Overall our approach results in similar price changes for both 1 April 2013 and 1 April 2014 (i.e. price changes are smoothed)

Improved impact assessment

We have improved our modelling of the price changes implied on 1 April 2013:

- Suppliers have provided more recent information that has allowed us to more accurately determine the baseline against which we assess the price changes
- This change is therefore presentational

Price change implied on 1 April 2013



The chart shows the average change to the price each supplier is allowed to charge in 2013/14.

The year-on-year change in the allowed price is similar, but also includes a CPI adjustment.

Price change implied on 1 April 2013

As guidance, the adjustments in previous slide do not reflect the following:

- The actual impact on average retail prices - distribution charges make up only a third of an end-users bill
- The likely impact on any particular consumer, or group of consumers since suppliers can choose how to apply the price changes across their customer base

Changes since the draft decision

The changes from the revised draft decision are relatively minor and summarised below:

- Capital expenditure allowance – adjustments to the suppliers' 2009/10 forecasts to removed expenditure directly funded by customers
- Operation expenditure allowance – revised econometric model of the effect of scale on opex as well as updated input data
- Constant price revenue growth – regional GDP growth rate now calculated over the five year period, rather than using the forecasts for each individual year

Changes since the draft decision (cont)

- Other line items – disposed assets set equal in real terms to disposed assets in 2009/10, which has tended to reduce 2013/14 revenues (affecting mainly Powerco)
- Other line items – other regulatory income updated to include resubmitted values from Vector
- Applying final input methodologies – mainly affects inflation forecasts

Cost of capital used in reset

Vector has expressed the following concern about the cost of capital used in the reset (stated at its 2012 annual meeting):

- “Vector’s regulated cost of capital (WACC) = 8.77%
- Comparable Australian lines companies’ WACC = 9.40% to 9.95%
- WACC should be higher in New Zealand”

Vector’s comparison with Australia WACC is problematic:

- Not a like-for-like comparison

Cost of capital used in reset

AER figures quoted by Vector do not take account of investor taxes, notably dividend imputation (although this is not obvious when first reviewing AER's numbers)

Need to take account of taxes on investors for a valid comparison:

- Using the Officer model, the AER vanilla cost of capital is in the range of 8.66% to 9.17% (c.f. our value of 8.77% using the Brennan-Lally model)
- On a post-tax basis the AER estimates range between 7.08% to 7.49% (c.f. our value of 7.78%)

Conclusion

Overall, our final decision is similar to the revised draft decision:

- Changes largely relate to use of updated information, application of final input methodologies (notably CPI forecast), and change to opex forecasts
- Overall effect on revenues between draft and final for most suppliers is relatively small
- One key change is presentational - how we calculate the price adjustment, but this change does not affect expected revenues

Any questions?

For more information

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Or visit:

<http://www.comcom.govt.nz/2010-2015-default-price-quality-path/>

For information on:

- The final decision
- The 2010-15 default price-quality path

Or visit:

<http://www.comcom.govt.nz/additional-input-methodologies-for-electricity-and-gas-dpps/>

For information on:

- The re-determined input methodologies