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Submission

To Commerce Commission

On whether the Commission should review or amend the cost of capital input methodologies (20/2/2014)

To: Brett Woods
Senior Analyst
Commerce Commission

By email to regulation.branch@comcom.govt.nz

EMA |Employers and Manufacturers Association (Northern) Inc
Private Bag 92066, Victoria Street West, Auckland 1142 | Telephone 09 367 0900

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EMA

1. BACKGROUND

This submission is made by the Employers and Manufacturers Association (Northern) Inc. [EMA].

EMA's membership is 4500 companies, including 1700 manufacturers, based in the top half of the North Island. Those companies are represented by 8000 operating or business units, which in total employ approximately 300,000 staff.

Our highly diverse membership includes companies and organisations involved in the manufacture, importation, supply, distribution and retail sale of most product types, and the provision of services in a wide range of service sectors including governmental, contractual, tourism, IT, banking, insurance and business advice.

The EMA is considered the leading employers' organisation by most business on issues that affect employment relations. It also takes an active role in cross industry initiatives and cooperates with government activities that will assist or improve the growth and development of business within New Zealand.

2. CONTACT

Further contact in relation to this submission should be made to:

Gilbert Peterson
Employers and Manufacturers Association
Private Bag 92-066
Auckland 1142

Telephone: 09-3670916
Mobile: 0274 949 629
E-mail: gilbert.peterson@ema.co.nz
Web: www.ema.co.nz

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3. Introduction

In association with MEUG and Consumer NZ we wrote to the Chair of the Commerce Commission, Dr Mark Berry, on December 19th 2013 requesting an urgent review of the cost of capital input methodology before the upcoming 2015 price-quality path resets for electricity transmission and distribution services.

This followed the questioning by the High Court *"whether empirical evidence and theoretical results justify [the Commission's] use of the 75th percentile estimate of the weighted average cost of capital (WACC) to set price-quality paths, and implied that use may be at odds with the section 52A(1)(d) objective of limiting the ability of regulated suppliers to earn excessive profits."*

The Commission found the Court's judgement created uncertainty and now seeks to address the concerns raised by the Court.

We find this response by the Commission most welcome.

The High Court's merit review decision indicates the mistaken approach by the Commission may have cost power consumers over $150m per year, with the total wealth transfer from consumers to monopoly suppliers over the relevant term would be well over $1billion.

4. Electricity costs a significant factor for business competitiveness

Electricity is a key business input. For some industries electricity costs are the highest non-capital related cost after employment and raw material expenses.

When line services are inefficient they add extra costs to distribution and transmission line charges, and when the cost of capital for a monopoly service is charged at more than its costs there are direct consequences for the competitiveness of those businesses using its services.

Energy prices have been rising faster on average than the rate of inflation for over decade, and now this year Transpower has kept up this rate of increase by increasing its charges at well over the inflation rate. As well flowing directly into the cost of goods produced in New Zealand they are also factored into interest rates and the exchange rate, all of which can penalise our exporters and import competing businesses.

We also support the more detailed submission by MEUG and expert advice by NZIER.

5. Our response to the questions listed in your paper of the February 20th.

3.1 Are the positive incentives provided by using the 75th percentile WACC significantly weakened until we address the concerns rasied by the Court?

The High Court decision has significantly undermined confidence that using the 75th percentile range in the cost of capital input methodologies is reasonable. We agree with the Commission that "until we decide whether to retain, reduce or remove the existing uplift to the mid-point WACC estimate, using the 75th percentile WACC is unlikely to provide the intended incentives for efficient investment". The uncertainty is real and significant for both line companies and end consumers and the Commission should urgently amend the cost of capital input methodologies in order to reach a decision as quickly as possible.

3.2 Should we bring forward a review of the cost of capital IMs (which would otherwise not need to be completed until January 2018) to resolve the uncertainty that compromises the purpose of the uplift?

Yes, most definitely.

3.3 Given the range of issues a comprehensive and robust review of the cost of capital IMs would need to cover, it is unlikely we could complete a review in time for any revised IMs to be applied in this year's DPP and IPP reset decisions. If that is the case, should we determine before November this year whether consideration of the Court's concerns warrants an IM amendment solely to the use of the 75th percentile?

A review of all cost of capital input methodologies may well not be possible before the third quarter of this year but such a review is unnecessary because possible changes, other than to the mid-point, could be considered in the review prior to January 2018.

Changing from the 75th percentile to the mid-point is feasible because there are no flow-on effects, and it's a desirable course of action to remove the uncertainty caused by the current assumption.

EMA supports an urgent amendment to the cost of capital input methodologies to change the specification from the 75th percentile to the mid-point, and an IM amendment solely to remove the use of the 75th percentile.

3.4 Given we must reset EDBs' and Transpower's price-quality paths for five years by November this year, is there any other option that avoids the risk of locking in higher prices for electricity consumers, if we were to later conclude that the uplift should be reduced or is not warranted?

We are unaware of other options.

3.5 What evidence is there in support of either the 75th percentile or credible alternatives?

We are unaware of any evidence that would support retaining the 75th percentile.

3.6 In selecting an appropriate WACC percentile, how significant is it that regulated outputs are inputs to other sectors of the economy?

EMA holds that monopolies, particularly state owned monopolies, should not be permitted to generate excessive profits. Such profits of state owned enterprises are in effect 'taxes', which also distort prices while depriving their customers of the benefits of a more competitive business environment.

In brief, the gains possible for New Zealand's wider economic performance and interest, should Transpower not be permitted to charge more than the reasonable 'mid-point' for its WACC are far greater than those that could accrue to Transpower.