

Our Ref: LTR 095

23 May 2011

Mark Berry
Chair
Commerce Commission
PO Box 2351
Wellington

Dear Sir

Electricity Distribution Business Default Price Quality Path – Proposed Starting Price Adjustments

This submission is made on behalf of Horizon Energy Distribution Limited (“Horizon Energy”) in response to the Commerce Commission’s Update Paper¹ dated 11 April 2011 and accompanying illustrative model². The Update Paper sets out a proposed method for determining whether adjustments to the price path component of the DPP will be made for each non-exempt EDB. This submission supplements our initial submission of 16 May 2011 which addressed the issues of most concern to Horizon Energy namely:

- a) The proposed approach potentially places Horizon Energy in the undesirable position of having to apply for a Customised Price-Quality Path (CPP) simply to prove to the Commission that our forecast outcomes will generate lower net revenues in comparison to the Commission’s forecast;
- b) The use of the 2009/10 position as the base year, after modifications to implement the Input Methodologies (IMs) is sensible. However we believe the manner in which this information is used to determine the projected profitability of each supplier can be improved by considering business specific information that is available publicly which still supports the Commission’s view of low cost regulation;
- c) We fully support the ENA’s further investigation of the use of a one standard deviation band around the stated 75th percentile WACC to address the difficulty in deriving projected profitability within a relatively low cost framework. This would support the Commission’s view of providing investment certainty to EDB’s who could “drift” within the band without resorting to a CPP or potentially face pecuniary penalties for breaches;

¹ 2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments

² Default/customised price-quality regulation: Illustrative Starting Price Adjustments (SPA) Model.xls

- d) As a minimum however we submit that any forecast assumptions the Commission uses must be reasonable for each supplier, and this is achievable without introducing the information asymmetry risks raised in the Update Paper;
- e) We support the Commission's proposal that any Starting Price Adjustment (SPA) should be forward looking, consistent with the incentives to invest requirement of the Commerce Act's Part 4 Purpose Statement; and
- f) We support the intention for the Commission's approval of avoided Transpower charges associated with a purchase of Transpower's assets to be addressed through the annual Compliance Statement process. However we do not support the proposal that the amount of the charge be limited to the nominal (annualised) amount avoided in year one of the allowed five year period. This is inconsistent with the IM definition of avoided Transpower charges and the incentive objectives of this provision.

The purpose of this supplementary submission is to present our further views on the Commission's proposed approach to estimating projected profitability for each supplier as set out in the Update Paper and the accompanying SPA Model.

Projected Profitability

The proposed SPA model generates a forecast of line charge revenues and a forecast of costs (costs are inclusive of an allowable return on assets equal to the 75th percentile vanilla weighted average cost of capital (WACC) consistent with the cost of capital IM) for each non exempt EDB over the DPP period. A SPA is calculated (ie: an increase or decrease in allowable revenues) in order to make the present value of the forecast revenues equal to the present value of forecast costs. In order to do this, the Commission proposes to apply four industry wide forecasting assumptions to every non-exempt EDB.

We note the ENA has prepared a detailed submission on the derivation of the industry wide forecasting assumptions and has concluded that the method and data used falls short of the degree of robustness necessary for the DPP.

Our 16 May 2011 submission included evidence to show that these industry-wide assumptions are detrimental to Horizon Energy and do not reflect the expected revenues and costs of our regulated business during the remainder of the DPP period. In particular:

- Horizon Energy's historical growth rates are materially lower than the industry average real output growth assumption used in the SPA Model (replicated in Appendix A). Horizon Energy will always be disadvantaged if the Commission uses industry wide assumptions for the purpose of determining output; and
- The 2010/11 projected revenues and costs as set out in the SPA Model are materially different from those actually achieved by Horizon Energy in that year (replicated in Appendix B).

We also submitted, without prejudice to the alternative approach put forward by the ENA which is fully supported by Horizon Energy, that should a forecasting trend approach be adopted, forecast assumptions must be based on information of relevance to each supplier.

We have analysed the outputs of the Commission's SPA Model using forecasting assumptions which are relevant for Horizon Energy. These include:

- Actual revenue, opex and capex for 2010/11 (presented in Appendix A)
- Forecast real growth rates for 2011/12 – 2014/15 based on the Commission's output index, but derived from Horizon Energy's historical output data – which generates an output index of 0.39% per annum after deducting the 1% GDP differential consistent with the Commission's approach (presented in Appendix B)
- Real capex and maintenance forecasts consistent with Horizon Energy's 2011 AMP for 2011/12 – 2014/15 (presented in Appendix C)
- Non maintenance opex derived using Horizon Energy's real output growth plus CPI for 2011/12 – 2014/15 (presented in Appendix C)

The impact of these business specific forecasting assumptions is presented below:

Commission's SPA Model		\$m
Projected Allowable Revenue year one (no adjustment)	\$	20.4
Allowable Revenue adjusted	\$	18.3
Starting Price Adjustment	-\$	2.1
Percentage change in starting price		-10%

Commission's SPA Model (Horizon Energy Forecast Assumptions)		\$m
Projected Allowable Revenue year one (no adjustment)	\$	19.6
Allowable Revenue adjusted	\$	19.1
Starting Price Adjustment	-\$	0.5
Percentage change in starting price		-2%

As demonstrated above, a major difference in the proposed SPA arises from the forecast of revenues in the 2010/11 year. The Commission's SPA model forecasts line charge revenues of \$20.4m for Horizon Energy in 2010/11. Our actual line charge revenues for the year are \$19.6m. This arises from the Commission's use of the industry wide output growth assumption, which as noted above is much higher than our network is able to generate.

After applying Horizon Energy's actual costs for 2010/11 and forecast assumptions to the Commission's SPA Model, we have calculated an allowable revenue of \$19.1m (based on the five year SPA approach) for 2010/11. This exceeds the Commission's estimate of allowable revenue of \$18.3m by \$0.8m. This, combined with the lower actual revenues for the 2010/11 year result in an estimated SPA of just \$0.5m (or 2%) for Horizon Energy as opposed to the \$2.1m (or 10%) presented in the Update Report.

This is a significant difference and illustrates how inappropriate the industry wide assumptions are for our business. We do not believe the Commission is justified in requiring Horizon Energy to incur the costs and devote the resources necessary to achieve a CPP simply to prove to the Commission that the industry wide forecasts are not appropriate for our business.

It is obvious from the difference in the 2011 actual performance when compared to the SPA model that the industry-wide forecasts trend away from what we are able to achieve. Accordingly, and consistent with section 53P(3)(b) of Part 4 of the Commerce Act which requires starting prices to be determined based on the current and projected profitability of each supplier we submit that should the Commission continue with its proposed approach, the forecasting assumptions must include the information which is available and relevant for our business.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Ajay Anand', written in a cursive style.

Ajay Anand
CHIEF EXECUTIVE

Appendix A – Horizon Energy Historical Growth Trend Data

Average Percentage Change 1996 - 2010 (trend growth)

	Energy Entering Network	Customer Numbers	Transforme r Capacity	System Length	System Capacity (kVA km)	Total Output
Aggregate	2.18%	1.53%	1.54%	1.30%	2.86%	2.10%
Non-exempt EDBs	2.08%	1.53%	1.28%	1.43%	2.72%	2.03%
Horizon	0.55%	0.72%	2.68%	0.94%	3.64%	1.61%
Horizon Revised	0.55%	0.72%	2.24%	0.94%	3.20%	1.47%

Source: Economic Insights EDB Database Aug 2009, HEDL Analysis

Average Percentage Change 1996 -2010 (log growth)

	Energy Entering Network	Customer Numbers	Transforme r Capacity	System Length	System Capacity (kVA km)	Total Output
Aggregate	2.04%	1.36%	1.29%	1.00%	2.29%	1.80%
Non-exempt EDBs	1.90%	1.35%	1.01%	1.01%	2.02%	1.68%
Horizon	0.33%	0.81%	2.09%	0.84%	2.93%	1.38%
Horizon Revised	0.33%	0.81%	1.87%	0.84%	2.71%	1.31%

Source: Economic Insights EDB Database Aug 2009, HEDL Analysis

Appendix B – Horizon Energy 2011 Forecast vs Actual

2011 Forecast vs Actual

	SPA Model				
	Forecast	Actual	Variance	Variance	
	(\$000)	(\$000)	(\$m)	(%)	
Net lines revenue	\$ 20,421	\$ 19,585	\$ 836	4.27%	
Opex	\$ 7,127	\$ 6,721	\$ 406	6.04%	
Commissioned assets	\$ 3,132	\$ 5,549	-\$ 2,417	-43.56%	

Note: 'Commissioned assets' includes capital contributions consistent with the Commission's SPA Model

Appendix C – Horizon Energy Forecast Opex and Capex

\$000	2011A	2012	2013	2014	2015
Nominal Capex	\$ 5,549	\$ 6,069	\$ 5,798	\$ 6,628	\$ 7,460
Nominal Maintenance	\$ 2,035	\$ 3,186	\$ 3,041	\$ 3,063	\$ 3,199
Nominal Non Maintenance Opex	\$ 4,686	\$ 4,812	\$ 4,942	\$ 5,076	\$ 5,213
Nominal Opex	\$ 6,721	\$ 7,998	\$ 7,983	\$ 8,139	\$ 8,412

