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Network Tasman Limited

Submission to the Commerce Commission

on

2010-15 Default Price Quality Path Starting Price Adjustments and Other Amendments - Update Paper April 2011

23 May 2011

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Update Paper: April 2011

General

1. Network Tasman Limited (NTL) appreciates the opportunity to submit on the Starting Price Adjustment (SPA) Update paper.

2. NTL is a member of both the Electricity Networks Association (ENA) and the PwC Group of 21 Electricity Distribution Businesses. NTL is a party to, and supports, the submissions made on the SPA Update paper by each of these groups.

Forward looking approach preferred

3. NTL supports the adoption of the more forward looking approach proposed in the SPA Update paper. We regard the proposed approach to be more in accord with the Purpose Statement and preferable to the previously suggested approach that relied on a single snapshot of EDB 2009-10 ROI's to derive Po adjustments. Any Po adjustment has ramifications over the whole regulatory period and it is therefore appropriate an attempt is made to consider future consequences on individual EDBs.

4. NTL prefers a SPA process based on forward modeling using building block costs for each controlled EDB over the alternative of a SPA adjustment derived from single year ROI data. The forward looking methodology should be better able to recognize firm specific circumstances.

NTL reservations

5. However NTL holds a number of reservations concerning:
    - The use of EDB specific single year (2009-10) building block data as the stepping off point for the SPA process
    - The use of industry wide data assumptions to model forward movements in key cost building block variables.

    Each of these issues are addressed further on in this paper.

6. The Commission acknowledges the starting year and industry assumptions could be problematic for some EDB. In mitigation it suggests EDB's can opt to apply for a CPP where they consider their specific circumstances are not properly recognized within the proposed SPA process. The CPP is put forward as a "safety valve".

Customised Price Path as a "safety valve"

7. NTL agrees, in principle, the CPP is a "safety valve" enabling EDB's to get due consideration of their firm specific circumstances at levels unlikely to be available under the SPA process. However on a practical level the value of the "safety valve" is overstated because CPP applicants face a significant number of hurdles and uncertainties:
   - All CPP applications will be resource intensive and expensive
   - CPP application costs are regressive and thereby discourage participation by smaller EDB's
   - CPP applications will not necessarily be considered in a timely manner as the Commission has the right to prioritise work and meet only a minimum quota of CPP hearings per annum across all controlled businesses, not just EDB's
   - The CPP will not just cover the Po adjustment but may also set a new rate of change for the EDB's price path
   - The EDB risks being made worse off as a consequence off applying for a CPP
   - There is no current precedents concerning the form and nature of the CPP processes

NTL prefers 3 Year View and no clawback

8. NTL supports a SPA proposal based on the three year NPV equivalent approach rather than the 5 year approach. This best reflects the emerging nature of the control regime and, being entirely forward looking, avoids uncertainties associated with retrospectivity. Likewise NTL considers the application of clawback should be avoided for reasons of simplicity and certainty.

9. Under the initial analysis provided in the SPA update paper NTL stands to gain a substantial positive Po adjustment and potentially a positive clawback amount. Should this proposal be put in place it is unlikely NTL would expose its consumers to the rate shock implied by these potential adjustments; it would contradict our previous price setting strategies.

SPA process and Discounts

10. The SPA draft paper has assessed NTL to be substantially under recovering its allowable building block revenue and has concluded that a substantial positive Po adjustment is warranted (a 49% uplift under the 5 year view and a 46% uplift under the 3 year view). The primary reason for this conclusion is that NTL's actual and projected revenue has been determined in the model on a *post discount basis*; that is after the $6.084m of discounts credited to consumers in 2009-10 have been removed from line revenue.

11. The proposal as it stands encourages NTL to uplift a Po adjustment that will fully recapture all the revenue NTL has chosen to allocate to its consumer owners as discounts. This is a nonsensical outcome and the logic of the proposed model suggests the higher the level of discounts the higher will be the positive Po adjustment available.

12. NTL concurs, in principle, with the way the SPA model tries to calculate the allowable level of revenue using a building block cost approach. This method will produce a consistent total revenue allowance across similar EDB's regardless of their type of ownership and how they choose to allocate surpluses to their owners (by retentions, dividends or discounts). However to maintain this consistency between ownership types, Po adjustments should then be derived by comparing allowable revenue against projections of *pre discount* revenue for Consumer Owned EDB's, regardless of whether the discount is of the *discretionary* or *posted* variety. In NTL's case reworking the model using pre discount revenue, NTL's projected positive Po adjustment would reduce down to the 10-12% level, which seems a considerably more sensible result.

Use of single year data as starting point

13. NTL has considerable reservation about using firm specific single year (2009-10) data as the starting point for the modeling projections. No account is taken of abnormal variability in any of the 2009-10 starting point measures such as revenue volumes, operating costs or capex. There is a risk projections made off the 2009-10 starting point data may capture a base number that is abnormally high or low and will consequentially lead to an over or understatement of key revenue or cost items in the forward projections driving individual firms SPA.

14. As an example NTL's revenue for 2009-10, like many other EDBs, was well ahead of forecast primarily because the 2009 winter was colder than normal. The subsequent 2010 winter was relatively benign and when combined with deteriorating business conditions due to the global financial crisis, NTL's volumes have been relatively static for the last 18 months. The SPA model will capture an abnormally high starting point for revenue and then make forward projections using long run industry growth assumptions. This will cause the revenue projection from the model to run ahead of NTL's actual revenue and this is likely to overstate the extent of the Po adjustment.

15. Capex allowances in the model are of particular concern because capex can vary considerably from one year to the next, especially for smaller EDB's. The SPA proposes to use EDB's 2010 actual Capex as the starting point and then grow this by 3.3% per annum nominal over the 2010-15 period. However for NTL the 2009-10 capex figure used as the starting point in the model is only 75% of the average capex spent in each of the previous 5 years and is 68% of the annual average capex projected to be spent in each of the next 5 years based on NTL's 2010 -20 Asset Management Plan. Consequently in these circumstances the model is likely to undershoot the revenue allowance for the deprecation and return on new capex and this is a disincentive to invest that will persist until the end of the regulatory period. It may be preferable to use an average capex amount taken from the last 5 years actual data or the next 5 years AMP projections to overcome of the risk of anomalies arising form reliance on single year data.

Industry wide assumptions

16. The SPA model proposes to project forward key 2009-10 firm specific data values using industry wide assumptions for Capex, Operating Costs and Real Revenue growth. NTL acknowledges that these projections are necessary but has a number of concerns about there development and use.

Real Revenue Growth

17. Firstly while projected real revenue growth looks reasonable from a long run historical perspective the following factors also could be considered before accept that long run trends are a valid for the remainder of the current regulatory period:
    - The last 10 to 15 years used to establish the SPA model real revenue growth assumption is based on a period of historically high economic growth for NZ. This high growth had slowed to low levels even before the global financial crisis struck at the end of 2009.
    - The global financial crisis plus the Christchurch earthquake have caused a change in consumer and business borrowing and spending behavior that suggests growth will stay below trend for the remainder of the current regulatory period.
    - Fuel and commodity real price growth and national savings initiatives have diverted consumer expenditure away from areas that have traditionally driven growth.
    - Policy initiatives and direct subsidies have lifted the profile and penetration of energy efficiency measures. These initiatives include home insulation, smart building development, solar water heating, CFL lighting and the electric motor program. These demand side initiatives are specifically designed to reduce the real growth rate in electricity consumption and dislocate it from GDP growth.
    - Even if the model's broad growth assumptions were correct there are very significant differences in growth levels on a regional basis. The general growth assumption may cause EDB's in low growth areas to take higher Po adjustments than is warranted by their circumstances.

Opex Growth

18. On first glance the assumption that EDB Opex will grow at a nominal rate of 3.8% per annum appears reasonable having considered both real growth and input price changes. However NTL again has some reservations concerning the backward looking nature of the derivation of these numbers. There are number of forward looking matters that are worth consideration and these include:
    - Commodity costs including fuel costs have increased considerably at and beyond the end of the data series used for the estimation
    - The aftermath of the Christchurch earthquake is likely to place strain on skilled labour costs and substantially increase insurance costs. It may also change some network design standards.
    - The UFB proposal and other major infrastructural projects both in NZ and Australia will ensure the market for skilled contractors remains relatively tight for the remainder of the regulatory period

- Real growth assumptions concerning operations and maintenance expenditure (but not overheads) could be referenced against the AMP data from EDBs in a similar manner to that used for capex.

Capex Growth

19. The Commission has used industry wide data from AMP's to forecast average capex growth allowances and is using a figure of 3.3%pa nominal for the 2010-2015 period . NTL has two reservations about this process:
    - The AMP capex projections used by the Commission for NTL (and as we understand it, for most other EDB's) are stated in real rather than nominal terms. The projections are all stated in 2010 dollars so the 3.3% annual growth figure derived by the Commission is a *real* rather than a *nominal* number. A further annual adjustment to the capex allowance for inflation is therefore warranted.
    - Capex growth is highly variable between firms as it depends on the underlying growth in the region served and the age and state of each network. Also plans to improve network security and reliability will take the individual EDB further away from industry average capex growth path. There is some opportunity for the SPA forward capex allowances for individual EDB's to be more closely referenced to their AMP forecasts.

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