



**CROSS SUBMISSION
ON
2010-2015 DEFAULT PRICE-QUALITY PATH
FOR ELECTRICITY DISTRIBUTION
DRAFT DECISION PAPER**

5 September 2011

INTRODUCTION

- 1 This cross-submission responds to points raised in submissions on the 2010-2015 Default Price-Quality Path (DPP) for Electricity Distribution (“the submissions”). Specifically, we set out Powerco’s response to the points in the following submissions:
 - 1.1 MEUG and Greypower’s concerns about price increases;
 - 1.2 MEUG’s comments that the WACC is favourable to EDBs;
 - 1.3 Evidence in a number of submissions on the forecasts, particularly the use of the Electricity Authority’s forecasts;
 - 1.4 Unison and MEUG’s comments on clawback;
 - 1.5 Wellington Electricity’s comments on cash flow, and that the Commission’s approach is inconsistent with clause 5.3.2 in the Input Methodologies; and
 - 1.6 Vector’s letter on the asset adjustment process.
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EXECUTIVE SUMMARY

1. An important theme running through the submissions is that the Commission has incorrectly estimated various cost components, which means that the aim of setting NPV=0 for each electricity distribution business (EDB) is not achieved. In this cross-submission we link the important points made in the submissions to this theme.
2. The submissions highlight a fundamental flaw with the Commission's approach of trying to eliminate any deviations between the Commission's estimate of the industry WACC and the expected rate of return for each EDB: while the attempt at false precision may deliver some price reductions, it will result in significant and unjustified price increases.
3. The evidence in the submissions shows that volume growth has been systematically over-estimated. In addition, the Commission's approach to modelling cash flow is inconsistent with clause 5.3.2 in the Electricity Distribution Input Methodologies.
4. We believe that issues raised in various submissions yet again highlight the validity of our previous proposal to allow EDBs to earn returns that fall within a reasonable range of the Commission's estimated WACC, rather than searching for a level of accuracy that is not possible or desirable under a DPP process. While our previous arguments about allowing a band of returns were based on the conceptual and theoretical attractions of such an approach, the evidence in the submissions indicates that it is a practical necessity.

ESTIMATION OF WACC

5. Powerco notes that the Commission observed at several points in its Draft Decision that it considered the current WACC settings – being based on financial inputs as at September 2009 – to overstate the current cost of capital for the EDBs. These comments were relied upon by MEUG when forming its view that too much ‘head room’ is likely to exist in the default price paths that were foreshadowed in the draft decision.
6. MEUG claims (at paragraph 3 of its submission) that the current decision on WACC is favourable to EDBs given that some WACC parameters have decreased since the Commission’s estimate in 2009. MEUG also claims that using 2009 estimates does not encourage efficiencies because EDBs will still be able to achieve the estimated WACC without reducing other costs.
7. However, the Commission’s comments in this regard are misguided and as a consequence have misdirected MEUG.
8. The suggestion that the current decision is favourable to EDBs is based on a misunderstanding of how efficient capital structure for regulated businesses is determined. There is a good reason why regulators fix WACC for the entire regulatory period, even though all the parameters used to estimate WACC change, often quite substantially over short periods of time. This reason relates to the need for regulated businesses to manage their risks with respect to the cost of debt and how the risk free rate impacts the cost of equity.

Cost of debt

9. Turning first to the cost of debt, the fundamental assumption in the Commission’s justification for assuming a five year term for debt (or, even if longer term debt is issued, that the margin will be applied to a five year risk free rate) is that rational EDBs should fix their debt costs for the term of the regulatory period. It was this assumption – and the Commission’s assertion that the NPV=0 rule must be met – that the Commission used to reject the proposals from a number of businesses to follow the lead of the AER and assume a ten year term for debt funding. The Commission’s specific observations about the use of interest rate swaps for this purpose included the following: [Commerce Commission, Input Methodologies – Reasons, December 2010, paras H4.33-H4.44]

In other words, firms are able to use interest rate swaps to re-price their interest costs (earlier than the maturity date of their debt) and lower their overall interest cost. Through the use of interest rate swaps firms can enjoy the benefits of long-term debt (secured funding and reduced refinancing risk) without having to pay the full cost of long term debt finance.

Interest rate swaps are used to hedge the risk-free rate component of their debt portfolios. This leaves the debt premium component matched to the term to maturity that the debt was originally issued for. Interest rate swaps are widely used in this way. ...

10. Thus if businesses complied with the Commission’s assumption that they would use interest rate swaps to lock in their debt over the regulatory period, then the subsequent fall in the risk free rate would have no effect whatsoever on their cost of debt.
11. In theory, a regulated business can decide how to manage the risk that its financing costs will deviate from this WACC. One approach is to re-finance debt at the fixed rates used by the regulator in setting WACC for the regulatory period. By adopting this strategy, the

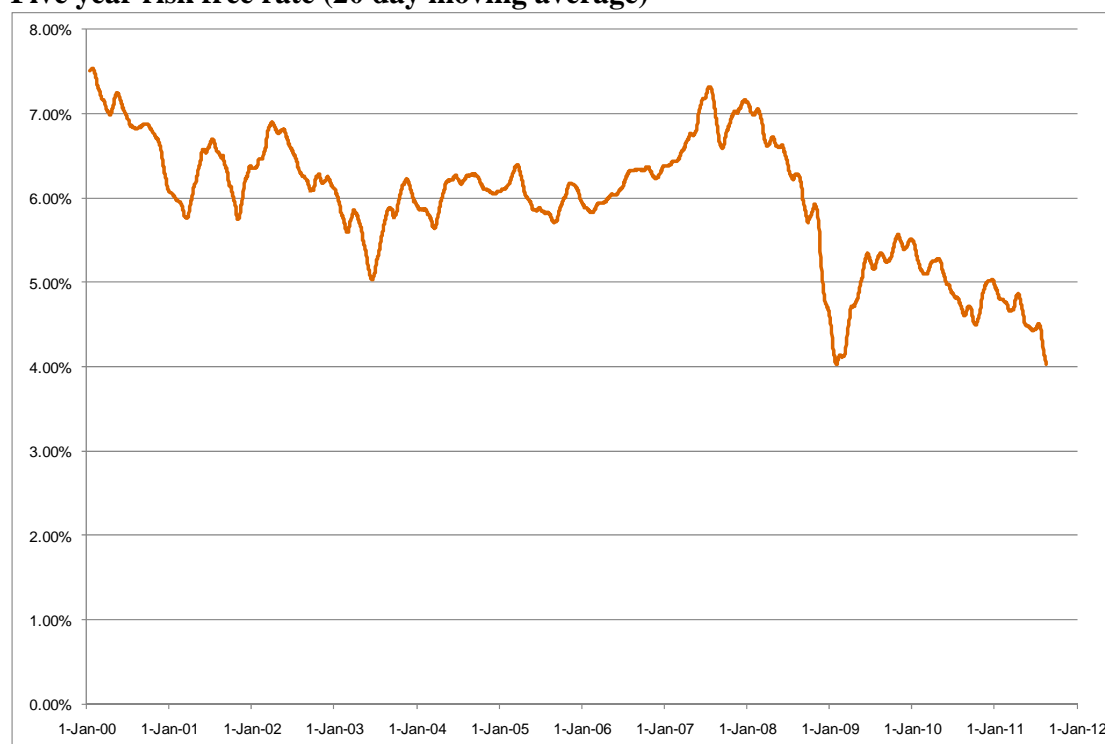
regulated business will be assured that its cost of debt over the regulatory period will be met by regulated revenues.

12. Alternatively, a regulated business could elect not to fix its debt for the regulatory period and allow its debt portfolio to be exposed to a floating interest rate. This means that the cost of debt incurred by the regulated business might be higher or lower than recovered from regulated revenues. These gains or losses would be entirely borne by the equity holders of the business, meaning that a fully floating debt position would be more risky—but potentially more rewarding—than fixing the cost of debt.
13. A risk-neutral position for EDBs—and how EDBs manage their debt portfolios in reality—falls somewhere between fully-fixed and fully-floating debt costs. To fix their position at the time of regulatory price resets, EDBs might take out some interest rate swaps (fixed for floating rate) rather than refinance their entire debt portfolio. The key point is that for a given WACC for the regulatory period, EDBs are able to construct a debt portfolio that reflects the amount of financing risk that correlates with the equity Beta (i.e. the amount of risk their shareholders would be willing to bear). This has two implications:
 - a. First, it means that changing WACC part way through the regulatory period will impose additional costs on EDBs and increase their risks, given that they would have fixed their capital structure to reflect the WACC used in the setting of the current DPP.
 - b. Second, it means that any reduction in the risk free rate that may have occurred since then would have had a very limited effect on the actual cost of debt for the EDBs.
14. Consistent with the Commission's assumptions, Powerco has an active interest rate risk management program inline with the above. It would be the height of inconsistency for the Commission to ignore this fundamental tenet of its rationale for equating the term of the risk free rate to the regulatory period and instead to assume that EDBs can now avail themselves of the apparent reduction in borrowing costs.

Cost of equity

15. Turning now to the cost of equity, the Commission's assertion that the EDBs' costs of equity would have fallen in line with the fall in the risk free rate are also naïve and demonstrate a severe limitation of the CAPM in the manner that it is being applied by the Commission.
16. The CAPM is a model (and an imperfect one) for estimating the forward-looking cost of equity as a function of other forward-looking variables – being the risk free rate, beta and market risk premium. However, in the manner in which it is commonly applied, the only forward-looking input that is applied is the risk free rate, with the beta reflecting a recent period (five to ten years) and with a very long term average being the predominant source of evidence for the market risk premium (that is, 50 plus years). Combining a forward looking risk free rate with a historical average for the market risk premium is practicable and reasonable for periods that appear normal in the context of history; however, the potential for gross errors exists where markets appear to be abnormal in the context of history.
17. Figure 1 sets out the behaviour of the five year risk free rate over the last 10 years.

Figure 1
Five year risk free rate (20 day moving average)



Source: Bloomberg predicted yield for 5 year New Zealand Government bonds.

18. This figure shows that the risk free rate has indeed fallen since September 2009; however, it also shows that the current level of the risk free rate is anything but normal, but is at approximately the same level as it was during the worst of the global financial crisis immediately after the fall of Lehman Brothers. This longer term context also shows that, even though the risk free rate that was measured in September 2009 was higher than current figure, that figure was lower than the average over the last decade.

19. An alternative – and more plausible – hypothesis is that the government bond rates have again fallen to very low levels in New Zealand (as they have in Australia) because the recent increase in global uncertainty has caused investors once again to switch holdings from risky assets to those that are perceived as the safest. In such a dynamic, even though the risk free rate may have fallen (because of the increased demand for safe assets), there is no reason to expect that the required returns for risky assets would have fallen – rather, given the increased global uncertainty, it is more likely that required returns for such assets would have increased, implying that the current day market risk premium would have risen above its long term average. The potential for this dynamic is ignored in the Commission’s analysis, however, given that it assumes that the long term historical average market risk premium remains correct in any market environment.

Conclusion of WACC

20. While consumers such as MEUG may wish to benefit from reductions in WACC, we would expect strong resistance to any suggestion that increases in WACC parameters within the regulatory period should be passed through to consumers. By fixing its estimate of the risk free rate and debt premium for the duration of the regulatory period, the Commission provides strong incentives for an appropriate low-risk debt management strategy (based on a high proportion of fixed rate debt), while ensuring that businesses that chose higher-risk options face the consequences of their choices.

21. Moreover, it is implausible to suggest that the cost of equity for risky assets has fallen in line with the risk free rate since September 2009. Rather, given the recent substantial increase in global uncertainty, it is more plausible that the cost of equity has risen – and that the Commission’s conclusions only follow from a mechanical application of a model that is ill suited for application when markets are not normal when set in the context of their historical behaviour.

22. The fact that the risk-free rate has declined since the start of the regulatory period does not make the 2009 WACC estimate generous to the EDBs, just as a hypothetical increase in the risk-free rate would not have made the WACC estimate unfavourable. Rather, a constant WACC over the regulatory period simply ensures that the risk of changes in WACC parameters rests with those best placed to manage them: the EDBs. If the WACC parameters were not fixed for the duration of the period, EDBs would either require a higher equity Beta to compensate them for the additional risk, or the risks would have to be passed through to consumers, both on the upside and the downside.

COMPANY-SPECIFIC DEVIATIONS FROM WACC

23. The Commission's approach to the DPP re-set is based on removing any expected deviations of company-specific rates of return from the industry-wide WACC. The submissions highlight that the difference between an EDB's rate of return and the estimated industry WACC can arise from two sources where an attempt to eliminate the differences would be inappropriate:
- a. **Forecasting errors.** Many submissions point out that if demand is predicted to grow faster than the actual growth realised by an EDB, the company will not generate sufficient revenues to earn the industry WACC.
 - b. **Company performance.** Submissions also highlight that the Commission's decision has the effect of rewarding poor performance by allowing inefficient companies to charge higher prices. If an EDB has incurred high operating or capital costs it will require price increases to earn the industry WACC.
24. By contrast with the evidence presented in the submissions, the Commission's draft decision reflects the opposite view of why company-specific rates of return differ from its estimate of industry WACC. The effect of the draft decision is to assume that all variation in returns is explained by market power.
25. We also highlight that the Commission's approach has the potential of resulting in an unpalatable outcome in that a sensible adjustment in the regulatory financial model on each specific issue raised in the submissions (such as the approach to recognising cash flows and generating demand forecasts) would result in price increases across the board. This may seem at odds with the Commission's responsibility to promote the long-term benefit of consumers.
26. In our view, the only way to resolve this conundrum is to allow a reasonable band for the expected rates of return in recognition of the uncertainties over forecasts and company specific performance.

Forecasting Errors

27. The first explanation for variations in company performance from estimated WACC is that volume forecasts contain errors. In our submission (at paragraphs 117 to 132) we explained why the Commission's reliance on the EA forecasts for the real revenue growth assumptions and forecasts in relation to Powerco was inappropriate. The submissions from other EDBs show that the same problems arise across all EDBs.
28. Two key points are made in the submissions on the likelihood of forecasting errors:
- a. The forecasts are an unjustified departure from historical rates—this issue is caused by the use of outdated Electricity Authority growth forecasts from 2009 based on census information from 2006.
 - b. The forecasts use an inappropriate mapping of regional growth forecasts to EDB network areas.
29. We describe these issues further under the sub-headings below.

The forecasts are an unjustified departure from historical rates

30. Many EDBs commented that the forecasting methodology used by the Commission to project real revenue growth is flawed and produces results that are at odds with historical trends.
31. Several submissions highlighted that the GDP forecasts used to project demand growth are unreliable. In its submission, Wellington Electric Lines Limited (WELL) attributed forecasting problems mostly to use of the Electricity Authority 2009 regional energy projections. These projections are based on 2009 GDP forecasts that are now out dated and inaccurate. The Commission has actually used more recent NZIER projections of GDP as direct inputs into the DPP forecasts for peak demand growth. In its submission, WELL quoted from a NZIER report which stated:
- “Introducing the updated (revised) GDP forecasts into the Electricity Commission’s forecasts reduces average demand growth from 2.4% in the original 2009 forecasts to 1.5%. A significant change is also observed at the regional level.”*
32. Vector also notes that the GDP and population forecasts used by the Electricity Authority to forecast energy growth are different to those used by the Commission to forecast fixed and peak demand based revenue growth. ENA also noted this issue. In its submission, Vector states that:
- “We note that the throughput growth forecasts are based in part on 2009 GDP forecasts that predicted higher GDP growth than has been experienced in reality.”*
33. The Vector submission also notes that in May 2011 Transpower reduced its peak demand forecasts, indicating that growth has been lower than previously anticipated.
34. e-dec Limited, in their submission on behalf of Marlborough Lines Limited and OtagoNet Joint Venture, also submitted that the revenue growth rates “appear to be unjustifiably high”. They also suggested that the Electricity Authority forecasts not be used as the Electricity Authority is “neither expert nor independent in formulating forecasts for EDBs”.
35. Horizon also took issue with the Electricity Authority forecasts, noting that:
- “The EA model is out of date, and includes underlying growth assumptions which are now inconsistent with more recent forecasts of GDP and population growth and most importantly with forecasts the Commission is using elsewhere in its model.”*
36. Eastland Network noted that the Commission’s assumed annual throughput growth at 1.59% was inconsistent with the assumed GDP growth rate of 0.08% and annual population growth of 0.09%. They stated that this result was implausible.
37. Other forecasting problems (in addition to GDP) were also highlighted in submissions:
- a. **The impact of population growth.** Vector notes the assumption that population growth has a perfect positive correlation with growth in ICPs is another source of error and upward bias. Vector’s submission shows that this was only true for two of the last nine years, and in all other years ICP growth was less than the rate of population growth.
 - b. **Fall in building consents.** Unison submitted that residential building consents have fallen significantly, and are now at a fifteen year low. As a result, the rate of new connections is also likely to be low for a few years. Unison suggested that in light of these circumstances, the Commission should use the low case population

projections—again suggesting that the Commission’s revenue growth forecasts are overstated.

- c. **Decline in energy intensity.** Unison also noted that there has been a long term declining trend in the energy intensity of New Zealand’s economy. The Commission assumes a one for one correlation between peak demand growth and GDP, which reverses the historical trend. No evidence is presented to justify this assumption, meaning again that the Commission’s demand forecasts are likely to be overstated.

38. These criticisms of the Commission’s forecasts are reasonable, and consistent with the concerns highlighted in our submission. To resolve these problems in forecasting real revenue growth, the Commission could either:

- a. attempt to retrofit the EA model by substituting the 2011 population and GDP forecasts into the Electricity Authority’s 2009 throughput forecasts; or
- b. use simple projections of historical trends based on actual throughput data. This is likely to be more accurate and better suited to the simple, low cost DPP process.

The forecasts use an inappropriate mapping of regional growth forecasts to EDB network areas

39. A number of the EDBs expressed concern that the geographic boundaries for regional economic growth forecasts do not match their distribution area. This issue was raised by Powerco in its submission in relation to the Coromandel area, where actual demand growth has been considerably lower than in the Waikato region used by the Commission to forecast growth for Coromandel.

40. Similar issues were raised by:

- a. Eastland Network—its network is a subset of the Hawkes Bay region and has a lower actual growth rate than the average for the region.
- b. Nelson—its network is a subset of the greater Marlborough region and has a lower actual growth rate than the average for the region.
- c. Unison—claim that it is inappropriate to use the Bay of Plenty growth forecasts for its entire network.
- d. Vector—claim that the Commission has incorrectly assumed that 100 percent of its ICPs lie within the Auckland region.
- e. Horizon—claim that the Bay of Plenty regional forecasts are not appropriate for their network sub-region.

41. This forecasting problem is exacerbated by the tendency for network areas operating within a region to have fundamentally different characteristics and drivers of growth—often one network is focussed on serving a major centre within the region, while another serves the rural hinterland.

42. There is no easy solution to this problem because GDP and population forecasts will never align with network areas. However, this again highlights the false precision of the

Commission's approach and the fact that company-specific variations in returns will arise from deviations between forecasts and actual outcomes. While the Commission's approach could be improved by relying on observed historical growth trends, some variation will remain due to the inherent uncertainty of forecasts.

Company Performance

43. The second explanation for variations in company performance from estimated WACC is that changes in company efficiency are greater or less than the industry average over the course of the regulatory period. This explanation was highlighted in the submissions made by consumer groups, particularly in the central North Island.
44. The TLC Customer Group and the Turangi/Tongariro Community Board highlighted their concern with the increasingly unaffordable prices in The Lines Company (TLC) distribution network. In particular these groups submitted that TLC has performed poorly, and should not be rewarded by a price increase—"There is widespread public doubt over the management and operational efficiency of the company".

The Commission's decision decreases incentives for efficiency

45. We note that even when considered against the Commission's own most recent assessment of the relative performance of EDBs, the Commission's decision rewards less efficient companies. Table lists the efficiency levels determined through the Commission's 2007 analysis of Multilateral Total Factor Productivity (MTFP). The MTFP levels shown were estimated by Meyrick, which classified EDBs into "efficient companies" (those with a MTFP level of greater than 1.0), "average companies" (those with an MTFP between 0.9 and 1.0), and "inefficient companies" (those with an MTFP of less than 0.9). When these efficiency levels are related to the price changes proposed by the Commission, three conclusions emerge:
- All companies classified as inefficient receive a price increase, with an average of more than 16 percent.
 - Most of the companies classified as having average efficiency receive a price rise, with an average of 13 percent.
 - Half of the companies classified as efficient receive a price reduction or no change, with an average price increase for this group of less than 2 percent.

Table 1: Price Changes Contrasted to Productivity Efficiencies¹

	MTFP	Indicative adjustment to net revenue in 2012/13 - assuming no smoothing	2012/13 maximum allowed net revenue \$m
<i>Efficient Companies</i>			
Electricity Invercargill	1.786	3.4%	12.9
Nelson Electricity Limited	1.478	3.0%	6.8
Horizon Energy Distribution	1.235	(9.8%)	19.6
Network Tasman Limited	1.135	8.5%	28.6
OtagoNet Joint Venture	1.114	8.4%	22.7
Vector Lines Limited	1.096	(8.5%)	402.4
Alpine Energy Limited	1.06	21.4%	30.4
Powerco Limited	1.034	(8.5%)	222.6
Weighted Average Price Change		(5.8%)	745.9

	MTFP	Indicative adjustment to net revenue in 2012/13 - assuming no smoothing	2012/13 maximum allowed net revenue \$m
Average Companies			
The Lines Company	0.975	20.9%	30.1
Aurora Energy	0.962	4.3%	57.9
Centralines Limited	0.945	25.4%	7.9
Eastland Network	0.943	(1.2%)	20.6
	Weighted Average Price Change	9.1%	116.6
Inefficient Companies			
Unison Networks	0.884	7.3%	91.2
Top Energy Limited	0.867	32.7%	29.8
Electricity Ashburton	0.755	10.9%	29.2
	Weighted Average Price Change	13.0%	150.2

Source: Meyrick and Associates, "Electricity Distribution Business Productivity and Profitability Update" (December 2007); Draft DPP Determination 2010-2015

¹MTFP data unavailable for Wellington Electricity Ltd

46. As with any efficiency benchmark, there are limitations to this analysis of MTFP. However, the key point is the most recent assessment of efficiency conducted by the Commission bears out the concerns made by submitters that the decision rewards inefficiency and poor performance, while penalising good performance in the middle of the regulatory period. This is precisely what incentive-based regulation is supposed not to do.

PROVISIONS FOR PROFIT CLAW-BACK

47. Submissions from Unison and MEUG claim that the Commission should retrospectively apply its decision by clawing-back the profits earned (or paying out the profits foregone) from the start of the regulatory period where the rates of return deviated from the industry-wide WACC. Vector submits that a claw back should not apply.
48. We have explained why forward-looking deviation of the rates of return from the industry-wide WACC may relate to company-specific performance factors, and hence why eliminating such deviation would have a very poor effect on incentives: it would reward poor performance and penalise good performance. The effect would be the opposite of how incentive-based regulation is supposed to work.
49. Retrospective elimination of such deviations has all these negative incentive effects, and more. Retrospective decisions have particularly poor incentive properties in that, in addition to protecting management from poor decisions or penalising it for good decisions made in the past, they also undermine the credibility of the regulatory regime, strengthening the rewards for under-performance and weakening the rewards for over-performance.
50. MEUG claims that a margin could be applied to the claw-back to ensure that companies are able to keep any efficiency gains. However, there is no robust way to apply a margin to such gains. As discussed above, we suspect that the impact of company performance in this industry is material although the actual level of efficiency gains achieved is specific to each company. Applying an industry-wide margin therefore blunts incentives to achieve any efficiency gains that are above the industry average.

TIMING OF CASH FLOWS IN SPA METHODOLOGY INCONSISTENT WITH CPP IM

Consistency with the CPP building block allowable revenue formula

51. Wellington Electricity's comments that the Commission's approach to cash flows is inconsistent with the approach in other countries. We also note that the Commission's new formula for calculating the 'building blocks allowable revenue' and thereby prices is inconsistent with the approach that is mandated in the Input Methodologies for the same calculation if a business proceeds with a Customised Price Path proposal.
52. Clause 5.3.2 of the Input Methodologies sets out a specific formula that is required to be used when calculating the 'building blocks allowable revenue', which is as follows:

$$\begin{aligned} & (\text{regulatory investment value} \times \text{cost of capital} + \text{term credit spread differential allowance} \\ & - \text{total revaluation}) \div (1 - \text{corporate tax rate}) + \text{total depreciation} + \text{forecast operating} \\ & \text{expenditure} - \text{other regulated income} + (\text{permanent differences} + \text{regulatory tax} \\ & \text{adjustments} - \text{utilised tax losses}) \times (\text{corporate tax rate} \div (1 - \text{corporate tax rate})) \end{aligned}$$

53. If it is assumed that capital expenditure is incurred evenly over the year and non-essential terms are ignored, this formula can be expressed as follows:

$$\begin{aligned} & (\text{Regulatory asset value} + \text{deferred tax balance}) \times \text{cost of capital} + \text{forecast capital} \\ & \text{expenditure} \times (\text{cost of capital} \div 2) + \text{term credit spread differential allowance} - \text{total} \\ & \text{revaluation} + \text{total (regulatory) depreciation} + \text{forecast operating expenditure} + (\text{increase} \\ & \text{in deferred tax balance} + \text{tax payable}) \end{aligned}$$

where the last term is the tax expense, which is given by:

$$\begin{aligned} \text{tax expense} = & (\text{post tax revenue} - \text{forecast operating expenditure} - \text{notional interest} - \\ & \text{total (regulatory) depreciation} + \text{amortisation of initial differences} + \text{amortisation of} \\ & \text{revaluations}) \times (\text{corporate tax rate} \div (1 - \text{corporate tax rate})) \end{aligned}$$

54. This formula is almost identical to Equation 2 that was derived by PwC¹ (the only difference being the very small difference in the return that is provided on capital expenditure that is referenced in the PwC discussion). PwC also demonstrated that this formula for calculating the 'building blocks allowable revenue' – which is the formula that is and consistent with the Commission's past practice and with the AER – provides a materially higher 'building blocks allowable revenue' than the formula the Commission has proposed in the draft decision.
55. The only other calculation required to set the price controls is to convert the 'building blocks allowable revenue' into a smooth stream of revenue over the regulatory period with the same present value, which is governed by clause 5.3.4. However, as PwC also showed, the assumed timing of revenue receipt within the year has not effect on the smoothed revenue stream and resulting prices provided that the smooth revenue is assumed to be received at the same time that the unsmooth revenue would have been received – which is necessarily the case.
56. Accordingly, the Commission's formula for deriving the building block delivers materially lower regulated prices than the Commission would be required to provide if that EDB proceeded with a Customised Price Path and no other change was made to the inputs. There is no rationale whatsoever for this inconsistency.

¹ PwC submission on behalf of Powerco, page 17.

57. Powerco submits that the Commission is not permitted to adopt in the SPA methodology a different approach to the timing of cash flows than is specified in the CPP IM. Such an approach would amount to inconsistent decision-making which risks rendering the Commission's decision unlawful. The unlawfulness of inconsistent decision making has been considered by the courts, which have held that fairness requires that decisions made by a regulator should not be contradictory, and thus substantial inconsistency in regulatory decision making is likely to be held to be irrational.
58. The inconsistency of the Commission's approach to the timing of cash flows in the DPP and CPP impugns the fairness of the regulatory regime. The Commission's approach means that a supplier's profitability will be measured considerably differently depending on whether it is subject to the DPP or a CPP. This will also create a difference in treatment between EDBs which are on the DPP and those EDBs which are on a CPP. Such inconsistency between related decisions cannot be justified.
59. Accordingly, Powerco submits that the Commission must revert back to the orthodox and internationally accepted practice of treating the timing of all cash flows as occurring at year end.

SUBMISSION ON ASSET ADJUSTMENT PROCESS CONCERNS

60. In an email on 29 August 2011, the Commission requested submissions from parties on the issues raised by Vector concerning permitted asset adjustments for EDBs.
61. Powerco considers that Vector's concerns are valid. Most critically, Powerco is concerned that some EDBs will have been unfairly disadvantaged by applying a conservative approach to the asset adjustments, when clearly the Commission has accepted a less than conservative approach to the exercise. Practically, this means that some EDBs' asset values will be deflated relative to other EDBs and to the precedent set by the Commission.
62. As Vector points out, EDBs should have a reasonable opportunity to re-submit the values for their asset base, on the basis of the principles that have been subsequently revealed by the Commission's approval of asset adjustments. While we cannot see how the Commission can claim that consultation on the asset base value is still open – every indication from the Commission suggests the decisions are made and adjustments have been approved – allowing EDBs to re-submit corrected asset adjustments is necessary to restore fairness to the regime and should be permitted if, as the Commission says, consultation remains open.

CONCLUSION

63. We are concerned about the prospect that correcting the errors in the draft decision might result in price increases for most, if not all, EDBs. While this may reflect a sensible approach to each issue (such as the approach to recognising cash flows and forecasting demand), such an outcome may be unpalatable for the Commission given its objective of promoting the long-term interests of consumers. Submissions from consumer groups, such as Grey Power Federation, highlight a general concern with price increases that would clearly be heightened if the outcome is more price rises.
64. The Commission can solve this conundrum by using rate of return bands. If the model projects a return for a specific EDB that is within the tolerance band, then no starting price adjustment is made. If the projected return is outside the range, then the starting price adjustment is made to bring the company to the closest edge of the range. This will clearly reduce the upward pressure on prices by only bringing EDBs that are outside the range within the reasonable range.
65. There are a number of compelling reasons for using the rate of return bands approach.
 - a. A band of reasonable returns explicitly recognises the other reasons that company returns are different from industry WACC. The range does not punish EDBs for overly optimistic forecasts of demand, and acknowledges that the relative efficiency of EDBs will change over time. We note that this is consistent with ENA's recommendation on the incorporation of a margin of error for the WACC.
 - b. A band of reasonable returns fits with the intention for the DPP process to be broad and relatively simple. The band approach acknowledges that the DPP model is not sufficiently accurate to conclude that EDBs are earning excess profits to a point estimate, and instead provides a range of returns that individual companies may fall within.
 - c. A band of reasonable returns is consistent with the objectives of the Act. The band provides incentives for EDBs to search for efficiency gains, but limits the ability to extract excessive profits—where excessive is clearly defined as earning returns that are above the upper limit of the reasonable range.
66. Overall, the concerns expressed in the submissions arise from the Commission's incorrect belief that setting the industry weighted average cost of capital (WACC) at the 75th percentile of WACC estimates "corrects" any other errors or incentive problems that arise from the Commission's decision. This approach is incorrect because estimating the industry WACC is a completely separate process from making other estimates that will determine EDB revenues and prices. Vector highlights in its submission that the 75th percentile was intended to address error in the WACC model only, and should not be used to account for other forecasting errors.
67. Since the estimation errors are independent—such as the widespread concern among EDBs that the Commission has over-estimated demand growth on their network and that this will lower their rate of return—a band of reasonable returns would enable forecasting errors and limited information about differences in company-specific performance to be explicitly recognised without translating into price shocks.