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**Network Tasman Limited**

**Submission to the Commerce Commission**

**on the**

**Starting Price Adjustments for**

**Default Price Quality Paths**

**Discussion Paper**

**10 September 2010**

## **General**

1. Network Tasman Limited (NTL) appreciates the opportunity to submit on the DPP Starting Price Adjustment process proposed by the Commerce Commission in its Discussion Paper of 5 August 2010.
2. NTL is a member of both the Electrical Networks Association (ENA) and also the PwC Group of EDB's and supports submissions made by each of these parties on this Discussion Paper.
3. This submission focuses solely on the sensitivity of the proposed Po adjustment process to both the distribution type and quantum chosen by those consumer owned EDB's subject to DPP control.
4. NTL has previously written to the Commission expressing its concerns about the inconsistent treatment of different distribution types within the Information Disclosure (ID) framework and the consequential impact on reported ROI's. PwC has also raised this matter in its submissions relating to the calculation of EDB Tax as part of the Input Methodologies.

## **Background**

5. Consumer owned EDB's can allocate surplus earnings back to their consumer owners by way of dividend or by discounts. Discounts, if used, can be further categorized as either Discretionary or Posted under Commerce Commission Information Disclosure framework.
6. Posted Discounts require an EDB to commit to and disclose discount amounts at the same time a pricing announcement / disclosure is published (usually at the commencement of the 1 April pricing year). From a consumer's perspective, other than receiving some discount information at an earlier date (3 months earlier in NTL's case); in all other respects there is no difference between Discretionary and Posted Discounts.
7. For Information Disclosure purposes Posted Discounts are deducted from gross line charge revenue and are effectively excluded from regulatory revenue and earnings and so do not enter the ROI calculation. Conversely Discretionary Discounts are included in regulatory revenue and earnings and are carried through into the ROI calculation in full, without any tax allowance.
8. Consequently an EDB using Posted Discounts will disclose a considerably lower ROI than if it credited an equivalent Discretionary Discount amount against the same gross line charge revenue. Additionally if Posted Discount levels / ratios are increased, ROI's will fall while if Discretionary Discounts are increased, ROI's will rise despite the underlying gross line revenue and line prices billed being identical in both cases.

9. EDB's that retain earnings or pay dividends will disclose a higher ROI than if Posted Discounts were used and a lower ROI than if Discretionary Discounts were used. Additionally disclosed ROI's will (correctly) not show any variation when dividend payout / retention ratios change.
10. The proposed Starting Price Adjustment Process outlined in the discussion paper works by comparing EDB's actual ROI's against some benchmarked ROI band. The ROI's used for an EDB are primarily based on Information Disclosure data and templates with the exception of the modified tax calculation. Because the ROI's for consumer owned EDB's are a function of distribution choice and quantum (Posted versus Discretionary Discount amounts) the potential Po adjustments therefore also become contingent on distribution choice and quantum.

### **Illustration**

11. To illustrate NTL's concerns we have selected 5 different and plausible distribution options available to NTL and reworked the Commission's Po spreadsheet model adjusting our 2009 ID data.
12. It is important to note that in each option considered the gross line charge revenue billed and paid by consumers / retailers remains exactly the same i.e. \$32.9m. The analysis only considers what happens if NTL's type and quantum of distribution is changed while, in all other respects, the 2009 ID data remains unaltered.
13. The range of options available to NTL and considered are:
  - A: Actual Discretionary Discount of \$5.909m (what NTL did in 2009)
  - B: An Equivalent Posted Discount of \$5.909m
  - C: No discounts offered; all earnings either retained or paid out as a dividend.
  - D: Discretionary Discount credit at the upper limit of \$11.0m (approximately equal to NTL's line business earnings before tax)
  - E: Posted Discount credited at the upper limit of \$11.0m.
14. The information below is derived using NTL's 2009 Disclosure Data and the Commission's Po adjustment model. A summary for each option is shown in the data table and graph at the end of this paper. Key points to note are:
  - A) At the 2009 actual Discretionary Discount level of \$5.9m, NTL's ROI is 9.05% which falls within the proposed WACC +/-1% dead band area where no Po adjustment is required.
  - B) Had NTL chosen to credit the \$5.9m as a Posted Discount the ROI would have been 4.96%. Applying the Starting Price Adjustment template the Commission would "offer" NTL a 19.7% Po line price uplift to push ROI up to the WACC-1% lower band. This would yield NTL an estimated additional \$5.3m pa. of line revenue.

- C) Had NTL either retained or paid out surplus earnings as a dividend instead of crediting discounts the ROI would have settled at and not varied from 7.82% which is inside the WACC +/- 1% dead band area where no Po adjustment is required.
- D) If NTL increased its Discretionary Discounts to an upper limit of \$11.0m the ROI would increase to 10.1% necessitating a 3.6% downwards Po adjustment with a projected \$1.18m pa. loss of line revenue. The Po adjustment would push the ROI back under the WACC +1% upper band.
- E) If NTL increased Posted Discounts to the upper limit of \$11.0m the ROI would fall to 2.5%. A 47% upward Po line price adjustment yielding a projected \$10.4m pa. increase in line revenue would be “on offer” from the model and would push ROI back to the WACC-1% lower band.

### Conclusions

15. NTL agrees with the way normal retentions and dividends are treated in the ROI calculation both within the ID and the Po model. Consistent outcomes are produced.
16. However NTL can produce a range of ROI's (and by implication Po adjustments) for any given level of distribution to its consumers. In the example ROI's for Options A,B&C vary from 9.05% down to 5.0% and for Options D&E from 10.1% down to 2.5%. From the same gross line revenue billed NTL's Starting Price Adjustment could vary from a 47% uplift (+\$10.4m pa.) to a 4% decrease (-\$1.2m pa.) depending on how discounts are structured.
17. NTL regards the comparative treatment of Posted and Discretionary Discounts to be inconsistent, irrational and problematic. There are significant inconsistencies and discrepancies in Po adjustments depending on the type and quantum of the discount applied. Additionally the relative outcomes between discount and dividend / retention models are also inconsistent.
18. The Po model “invites” NTL to swap from Discretionary Discounts to Posted Discounts. This essentially cosmetic change would produce a positive and material Po uplift for NTL given the Starting Price Adjustment model proposed. We can not see how this is justified or in the best interests of consumers when both consumers and the company remain in exactly the same net financial position regardless of which discount method is adopted. Why should the ROI's and Po adjustments differ between these alternatives? Providing a Po increase to consumers who receive a posted discounts and setting  $Po=0$  if they received the same discount but on a discretionary basis seems illogical and unwarranted. Additionally the fact that the Po adjustment can vary with the quantum of either type of discount is also illogical.
19. NTL submits that the:
  - Po adjustment process should not be sensitive to either the type or the quantum of discounts / distributions adopted by consumer owned EDB's.

- Commission in the first instance should reassess the way Posted and Discretionary discounts are treated within the Information Disclosure templates so consistency is obtained between each type of discount and with firms using conventional dividend / retention approaches.
- Failing that the Commission should reformulate the Starting Price Adjustment model so that Po adjustments become independent of discount type and quantum.

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10 September 2010

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## Data

<b>Network Tasman Limited</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>E</b>
	<b>Discretionary Discount Actual</b>	<b>Posted Discount Equivalent</b>	<b>Dividend or Retention Equivalent</b>	<b>Discretionary Discount Upper limit</b>	<b>Posted Discount Upper limit</b>
<b><u>NTL Line Business Revenue 2009</u></b>	\$,000	\$,000	\$,000	\$,000	\$,000
Gross Line Revenue Billed	32,917	32,917	32,917	32,917	32,917
Other regulatory income	4,427	4,427	4,427	4,427	4,427
Total Line Business Revenue	<b>37,344</b>	<b>37,344</b>	<b>37,344</b>	<b>37,344</b>	<b>37,344</b>
Line Charge Discounts	5,909	5,909	0	11,000	11,000
<b><u>Applying 2009 Information Disclosure Template</u></b>					
Total Regulatory Revenue	37,343	31,434	37,343	37,343	26,343
Regulatory EBIT	10,955	5,046	10,955	10,955	(45)
Regulatory Tax	(131)	(131)	1,642	(1,658)	(1,658)
Revaluations	4,044	4,044	4,044	4,044	4,044
Regulatory Profit (pre financing)	15,130	9,221	13,357	16,657	5,657
Regulatory Investment Value	144,667	144,667	144,667	144,667	144,667
ROI (calculated as per ID requirements)	9.48%	5.39%	8.25%	10.53%	2.93%
<b><u>Applying the Proposed Po Methodology</u></b>					
ROI (Re-calculated as per Po proposal)	9.05%	4.96%	7.82%	10.10%	2.50%
<b>Assessing Potential for Po Increases</b>					
<b>Using proposed 1% LOWER ROI Band Limit</b>					
Implied Lower Limit for ROI	7.53%	7.53%	7.53%	7.53%	7.53%
ROI Variance for Po Adjustment	1.52%	-2.57%	0.29%	2.57%	-5.03%
Building Block Maximum Revenue	32,373	34,906	34,906	30,191	34,906
Building Block EBIT	5,985	8,517	8,517	3,803	8,517
Po Regulatory Revenue Adjustment to ROI Band	(3,652)	<b>5,306</b>	(603)	(5,317)	<b>10,397</b>
Po Revenue change relative to Distribution Revenue	-17.47%	<b>35.38%</b>	-2.88%	-25.43%	<b>104.95%</b>
Po Revenue change relative to Line Charge Revenue	-11.09%	<b>19.65%</b>	-1.83%	-16.15%	<b>47.44%</b>
<b>Assessing Potential for Po Decreases</b>					
<b>1% UPPER ROI Band Limit</b>					
Implied Upper Limit for ROI	9.53%	9.53%	9.53%	9.53%	9.53%
ROI Variance for Po Adjustment	-0.48%	-4.57%	-1.71%	0.57%	-7.03%
Building Block Maximum Revenue	36,507	39,039	39,556	34,325	39,039
Building Block EBIT	10,118	12,650	13,167	7,936	12,650
Po Regulatory Revenue Adjustment to ROI Band	998	9,440	4,047	<b>(1,184)</b>	14,531
Po Revenue change relative to Distribution Revenue	4.78%	62.94%	19.36%	<b>-5.66%</b>	146.67%
Po Revenue change relative to Line Charge Revenue	3.03%	34.95%	12.30%	<b>-3.60%</b>	66.30%
<b>Notes</b>	In all cases above NTL bills consumers total gross line charges of \$32.917m over the year but distribution type and amount varies:.				
A	Discretionary Discount Actual : NTL actual approach to discounts in 2009 with \$5.909m discount on discretionary basis				
B	Posted Discount Equivalent : Effect had NTL chosen a Post Discount approach at same discount level of \$5.909m				
	Note - only difference between A&B is timing of discount <i>announcement</i> otherwise no difference for consumers				
C	No discounts used, earnings retained or paid as dividend; no impact on reported ROI , consumers worse off than in A or B				
D	Discretionary Discount Option but with the discount set at the upper limit of line business profit before tax (\$11.0m).				
E	Posted Discount option but with the discount set at the upper limit of line business profit before tax (\$11.0m).				

