

E 5/14

28 August 2009

Karen Murray
Chief Advisor
Network Performance Branch
Commerce Commission
PO Box 2351
WELLINGTON 6140

NPB@comcom.govt.nz

CROSS SUBMISSION ON INPUT METHODOLOGIES

- 1 This letter sets out Unison's cross submission on the Input Methodologies Discussion Paper and the Revised Draft Guidelines for the Approach to Estimating the Cost of Capital.

General Comments

- 2 We support Vector's recommendations, particularly as summarised in paragraphs 14 and 21 to 51 of their submission.¹
- 3 We support Telecom's discussion of workable competition, which is consistent with our understanding of workable competition.² We also agree with the discussion in section 2 of Telecom's submission, discussing the intent of the amendments to the Commerce Act.
- 4 We agree with Telecom's comments that the discussion paper adopts contentious material from previous regulatory regimes. The amendments to the Commerce Act provide the opportunity for the Commission to adopt a fresh and constructive position.

Form of the Price-Quality Path

- 5 The Major Energy Users' Group (MEUG) supports the use of regulation "better match[ing] individual consumer price and quality trade-offs) as opposed to covering aggregate revenues" (MEUG, paragraph 8).³ This is consistent with our submission that there should be a single price-quality path.

¹ Vector, *Submission to Commerce Commission on Input Methodologies Discussion Paper*, 17 August 2009.

² Telecom, *Part 4 Commerce Act 1986 Input Methodologies Consultation*, Public Version, 5 August 2009.

³ Major Electricity Users' Group, *Submission on Input Methodologies Discussion Paper*, 31 July 2009.

Reopeners

- 6 We disagree with MEUG's recommendation that there should be no re-openers under a Default Price-Quality Path (MEUG, paragraph 16).

Cost Allocation Methodology

- 7 We agree with Mighty River Power's (MRP's) support of the avoidable cost allocation methodology (ACAM), and further note and support MRP's comments that:⁴

"Application of ACAM, for financial separation purposes, is not inconsistent with workably competitive market outcomes." (MRP, paragraph 83 and discussion in paragraphs 80-82)

"We do not believe the Commerce Commission has presented any economically or legally robust arguments against ACAM." (MRP, paragraph 48).

- 8 We welcome MRP's recognition that a Fully Allocated Cost Methodology (FACM) approach, if applied to investments in non-regulated activities would effectively be a tax on those activities (MRP, paragraph 69) and act as a barrier to entry into the relevant markets.
- 9 Similarly, we note Contact Energy's concern that:

"use of a [FACM] could deter economically sensible consolidation of network businesses leaving New Zealand facing higher network costs than is warranted".

This is consistent with our submission that the approach proposed in the discussion paper removes the incentives for the acquisition of other regulated businesses.

- 10 However, we are concerned that the mechanism proposed by MRP eliminates the incentives for consolidation of regulated businesses. In particular, MRP's proposals "would mean multi-network utilities would be restricted from earning more than their stand-alone costs for each of their regulated services individually and in combination" (MRP, paragraph 64). This means that there are no incentives for consolidation of regulated businesses.
- 11 Our proposed approach to sharing efficiency gains is consistent with Vector's proposal for
- "a standalone cost ("SAC") approach applied across all regulated business in combination, combined with an explicit mechanism to allow

⁴ Mighty River Power, *Input methodologies and default price-quality paths for EDBs*, 29 July 2009.

investors to benefit from rationalisation of regulated businesses” (Vector, paragraph 31).

In particular:

- a The SAC approach can be applied across all regulated businesses, as proposed by both MRP and the Commission;
- b The magnitude of efficiency gains are equal to the difference between the SAC for all regulated businesses and the sum of the SAC for each regulated business unit;
- c Under our proposal half of the efficiency gain would be allocated to consumers and the other half would be allocated to suppliers; and
- d Allocating part of the efficiency gain to suppliers requires that part of the efficiency gain be added back to the cost base used for assessing returns and setting the Default and Customised Price Paths.

12 We agree with MRP that:

[FACM does] not identify whether monopoly profits are being earned or cross-subsidies exist, which is the principle function of financial separation. The results of application of FACM will be a function of arbitrary cost allocations. (MRP, paragraph 52).

This statement is consistent with our submission that comparison between regulated business units will become increasingly irrelevant as cost allocations and regulated asset bases change over time.

13 We agree with MRP (paragraphs 75-76) and Vector (paragraph 32(b)) that the efficiency gains to be allocated are only those from the supply of regulated services, not those from the supply of unregulated services.

Regulatory Asset Base (RAB)

14 Consistent with our submission, MEUG notes that “CPI might not be the best index for existing capital” and suggests that a 1 April 2010 ODV would be a “more thorough option” for the RAB (MEUG, paragraph 6).

15 We support Telecom’s comments on asset valuation (paragraph 8).

Regulatory Taxation

16 Unison supports the report on taxation issues from PriceWaterhouseCoopers (on behalf of the Electricity Networks Association).⁵ For the avoidance of doubt, we support the position that comprehensive deferred tax accounting be adopted for

⁵ PriceWaterhouseCoopers, *Electricity Networks Association, Comment on Regulatory Tax Issues*, August 2009.

the regulatory tax allowance together with the recommendation that for regulatory purposes the opening deferred tax balance should be set to zero for the new regulatory regime.

Weighted Average Cost of Capital (WACC)

- 17 We confirm our support for the ENA's cross submission on the cost of capital.⁶ In particular, we support the points that:
- a There should not be complete reliance on the tax-adjusted (Brennan-Lally) CAPM (see also LECG, paragraphs 19-24 and Telecom, paragraphs 34-38)⁷;
 - b Allowances for unsystematic risk could be included in the rate base (LECG, paragraph 30); and
 - c Some unsystematic risk can be addressed by way of an option multiplier of the form proposed by Dr Graeme Guthrie.⁸
- 18 We support Contact Energy's comments that business profitability is inherently uncertain and that in the Commission's comparison of WACC with actual network company returns, only persistent excesses should become a focus for action.⁹
- 19 We disagree with MEUG's recommendation, and that of Ireland Wallace & Associates (IWA),¹⁰ that leverage should be assumed to be zero (MEUG, paragraphs 11-13). Our key concern is that the assumption of zero leverage could then be established as an underlying assumption of the Commission's when evaluating financeability tests, thereby essentially negating the purpose of such tests.
- 20 The fact that the cost of capital is minimised when leverage is zero is an artifice of the particular model selected by the Commission, and that does not form a sound basis for selecting the appropriate level of leverage. As noted in the ENA's cross-submission, IWA's conclusion that debt is an inefficient form of financing is contrary to the capital structure that infrastructure firms employ in practice.
- 21 We disagree with the comments of MEUG that setting the WACC above the mid-point "skew[s] [the] bias in favour of EDBs at the expense of consumers" (MEUG, paragraph 14). As recognised by the Commission, the greater cost to consumers is that investment does not occur.
- 22 MEUG's views on the WACC, and those contained in IWA's report, are not consistent with the long history of submissions from experts on WACC, including

⁶ Electricity Networks Association, *ENA cross submission – agenda items for cost of capital workshops*, 28 August 2009.

⁷ Glenn Boyle, Tim Irwin, and Tony van Zijl, *Comments on the Commerce Commission's proposed approach to estimate the cost of capital*, LECG, 11 August 2009.

⁸ Graeme Guthrie, *Incorporating Real Options in Regulated Prices*, 13 August 2009.

⁹ Contact Energy Limited, *Submission to the Commerce Commission on the Input Methodologies*, 31 July 2009.

¹⁰ Garth Ireland, *Commerce Commission Input Methodologies Discussion Paper Submission*, Report to Major Electricity Users' Group, Ireland, Wallace & Associates Limited, 31 July 2009.

those in the current consultation from Dr Alex Sundakov (on behalf of Unison),¹¹ Synergies (on behalf of Vector),¹² LECG (on behalf of the ENA), and previous submissions by Unison (including reports from CRA International).

Pricing Methodology

- 23 We disagree with MEUG's view that the distribution pricing methodology should be mandatory (MEUG, paragraph 9).
- 24 We also disagree with the general theme in MRP's cover letter that suggests that prescriptive regulation of pricing methodologies may be appropriate.
- 25 Please contact me directly if you require further information on this cross submission on 06 873 9301.

Yours sincerely



Ken Sutherland
Chief Executive

11 Alex Sundakov, *Submission on Input Methodologies: Regulatory Cost of Capital*, Castalia, 13 August 2009.

12 Euan Morton, *Selected issues arising from Commerce Commission's Input Methodologies Discussion Paper*, An expert statement, Synergies Economic Consulting, August 2009.