



# MAJOR ELECTRICITY USERS' GROUP

9 August 2010

Karen Murray  
Regulation Branch  
Commerce Commission

By email to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

Dear Karen

## **Submission on Pan Industry Input Methodologies for cost allocation, treatment of taxation, pricing methodologies, rules and processes and Transpower asset value**

1. This is a submission by the Major Electricity Users' Group (MEUG) on the following Commerce Commission (the "Commission") papers in relation to certain parts of the consultation on pan industry Input Methodologies (IM) as follows:
  - Cost allocation, treatment of taxation, pricing methodologies and rules and processes in the paper "Methodologies Electricity Distribution Services, Draft Reasons Paper, dated 18<sup>th</sup> June 2010<sup>1</sup>. Suppliers of Electricity Distribution Services are referred to as EDBs.  
MEUG will be making separate submissions on IM for cost of capital, asset valuation and Customised Price-Quality Path (CPP) requirements for EDBs.
  - Cost allocation, treatment of taxation, pricing methodologies and rules and processes in the paper "Input Methodologies Gas Pipeline Services, Draft Reasons Paper", dated 21<sup>st</sup> June 2010<sup>2</sup>. Suppliers of Gas Distribution Businesses are referred to as GDBs and include Gas Transmission Businesses (GTBs) unless otherwise stated.  
MEUG will be making separate submissions on IM for cost of capital, asset valuation and CPP requirements for GDBs and GTBs.
  - Cost allocation, treatment of taxation, rules and processes and asset valuation in the paper "Input Methodologies Transpower, Draft Reasons Paper", dated 25<sup>th</sup> June 2010<sup>3</sup>.  
MEUG will be making separate submissions on IM for cost of capital for Transpower.
2. MEUG comment on each Input Methodology is set out in the appendix to this submission.
3. Aspects of the draft IM MEUG suggest the Commission reconsider in the order in which they are mentioned in the appendix are:
  - a) Regulated parties should identify and explain when default accounting based approach has not been used;

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<sup>1</sup> <http://www.comcom.govt.nz/assets/Pan-Industry/Input-Methodologies/Draft-Reasons-EDBs/Input-Methodologies-Electricity-Distribution-Services-Draft-Reasons-Paper-June-2010.pdf>

<sup>2</sup> <http://www.comcom.govt.nz/assets/Pan-Industry/Input-Methodologies/Draft-Reasons-GPBs/Input-Methodologies-Gas-Pipeline-Services-Draft-Reasons-Paper-June-2010.pdf>

<sup>3</sup> <http://www.comcom.govt.nz/assets/Pan-Industry/Input-Methodologies/Draft-Reasons-Transpower/Input-Methodologies-Transpower-Draft-Reasons-Paper-25-June-2010.pdf>

- b) Proposal the Commission can access information in relation to DPP and CPP cost allocations that will not be published;
  - c) Regulated parties should identify and explain when subsidies have been applied;
  - d) Proposal local authority rates and Commerce Commission, EC and GIC levies be treated as pass-through costs;
  - e) Proposal CPP application costs and transmission charges be treated as Recoverable Costs by EDBs;
  - f) Proposal Instantaneous Reserve costs be treated as Recoverable Costs by Transpower;
  - g) Giving consumers the right to seek DPP re-openers;
  - h) Implementing the Incremental Rolling Incentive Scheme without biasing the scheme in favour of Part 4 regulated service providers; and
  - i) Risks around formation of Transpower New Investment Contracts are sufficient to warrant a review to consider if regulations to support the negotiating framework are needed.
4. Nothing in this submission is confidential.

Yours sincerely



Ralph Matthes  
Executive Director

## Appendix: MEUG comments on Pan Industry Input Methodologies

Input Methodologies Draft Decisions and Draft Reasons	MEUG submission
<p><b>Cost allocation IM</b></p> <p>The draft IM for EDBs and GDBs is a default accounting based approach with flexibility in some cases, eg materiality in which case ACAM can be applied.</p> <p>Detailed disclosure of cost and asset allocation methodologies and results is required.</p> <p>The Commission may seek information from EDBs and GDBs that is deemed commercially confidential and therefore not made public; in order to assist the Commission improve DPP and CPP.</p>	<p>Agree provided reasons for departure from the default accounting based approach are transparent and will allow interested parties an opportunity to expose make poor decisions by EDBs and GDBs.</p> <p>Agree.</p> <p>This is risky. By definition Part 4 services are subject to weak competitive pressures and caution must be exercised in assessing claims by EDBs and GDBs that information is commercially sensitive. Transparency is necessary to allow interested parties to assess the effectiveness of Part 4 and also to mitigate the risk of Part 4 entities capturing the regulator.</p> <p>MEUG can understand why purchasing and labour resourcing strategies should not be disclosed but it is not obvious why cost allocation details would have any commercially confidential information.</p>
<p><b>Treatment of taxation IM</b></p> <p>Draft IM proposes deferred tax approach for EDBs and GDBs and tax payable approach for Transpower.</p> <p>Notional leverage of 40% is proposed for EDBs, GDBs and Transpower.</p>	<p>No view at this stage.</p> <p>No view at this stage.</p>
<p><b>Pricing Methodologies IM</b></p> <p>The EC sets the Transpower Pricing Methodology and under proposed changes in the Electricity Industry Bill the Electricity Authority will set pricing methodologies for EDBs.</p> <p>Overall approach for EDBs and GDBs is efficient pricing implemented through pricing principles.</p> <p>Pricing principles for EDBs to be consistent with approach by EC.</p>	<p>Noted.</p> <p>Agree.</p> <p>Agree.</p> <p>Agree with the draft pricing principles for EDBs in table 7.1 provided where an EDB has prices that do not "signal the economic costs of service provision" (pricing</p>

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<p>For GDBs pricing principles to be consistent with Gas Authorisation.</p> <p>EDBs and GDBs must disclose pricing methodologies they apply and demonstrate extent consistent with IM pricing principles.</p> <p>Pricing Methodology IM will not apply to DPP.</p> <p>Pricing Methodology IM can apply to CPP.</p>	<p>principle 1) because of subsidies that arise from “compliance with legislation and/or other regulation”, then the EDB must when disclosing their pricing methodology state which prices have such explicit subsidies. Without this information parties monitoring EDBs will be left guessing which prices have subsidies and which do not.</p> <p>Agree.</p> <p>Agree.</p> <p>Agree.</p> <p>Agree.</p>
<p><b>Rules and processes IM</b></p> <p>Price is specified as:</p> <ul style="list-style-type: none"> <li>• Weighted average price cap for EDBs.</li> <li>• Weighted average price cap for GDBs and either weighted average price cap or total revenue cap for GTBs.</li> <li>• Total revenue cap for Transpower.</li> </ul>	<p>Agree.</p> <p>Agree.</p> <p>Agree.</p>
<p>Initial pass-through costs for EDBs, GDBs and Transpower comprises:</p> <ul style="list-style-type: none"> <li>• Local authority rates.</li> </ul>	<p>MEUG do not agree local authority rates should be included as a pass-through because they are not entirely “outside the control of the supplier” criteria in the draft decision (paragraph 8.4.4). EDBs can and should make submissions to rating authorities if they consider their rates are excessive just as any other business has to.</p> <p>The Commission should write to all Part 4 regulated businesses and ask if they or any trade-association they are affiliated too has ever made submissions to any local authority or select committee of Parliament in relation to how local authority rates are set. If there have been instances, then this will demonstrate that in practice Part 4 regulated businesses act as if they can influence those costs.</p> <p>The criteria of being outside the control of the supplier and being unable to accurately forecast could be applied to any item that has to be imported. EDBs cannot control or know for sure what the exchange rate will be over the next few months let alone years. On this basis and using the logic in paragraph 8.4.4 of the draft decision then all equipment and services EDBs must import should be allowable pass-through</p>

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<ul style="list-style-type: none"> <li>Regulatory levies set by the Commerce Commission and EC or GIC as appropriate.</li> </ul>	<p>costs.</p> <p>The same argument against allowing pass-through of local authority rates applies to Commerce Commission, EC and GIC levies. As these amounts are relatively small and we believe there would be benefits in simplifying the calculation and reporting of weighted average price cap if there were no pass-through costs.</p>
<p>The Commission proposes a new cost category "Recoverable Costs" for partially controllable costs compared to what the Commission considers are entirely uncontrollable costs classified as "Pass-through" listed above.</p> <p>Initial Recoverable Costs for EDBs comprise:</p> <ul style="list-style-type: none"> <li>CPP application costs considered by the Commission that should be recoverable by the supplier.</li> <li>Transmission charges</li> </ul> <ul style="list-style-type: none"> <li>New investment contract charges paid to Transpower or payable to another transmission equivalent service provider.</li> <li>Avoided transmission charges</li> </ul> <ul style="list-style-type: none"> <li>Net incremental carry-forward under the IRIS. This is the only initial recoverable cost proposed for GPBs.</li> </ul>	<p>There is insufficient detail in the Commission paper to understand exactly how the Commission will decide what costs suppliers will be able to recover and thereby on charge consumers. Without that information MEUG cannot accept this proposal.</p> <p>The wave of transmission investment already approved by the EC in excess of \$2 billion will be on-stream and charged to Transpower customers within the next three years. These approved amounts are known and therefore the impact on EDBs is predictable. Therefore these costs need not be treated as being akin to pass-through costs.</p> <p>After the wave of transmission investment, the EC expect grid reliability investment through to 2040 to be between \$250 and \$300 million (NPV in 2015 \$'s)<sup>4</sup>. This is not an unmanageable sum to be included in normal DPP operating costs.</p> <p>MEUG notes gas transmission charges are not a proposed recoverable cost in the Gas IM Draft Reasons paper. The Commission should explain why electricity transmission should be a recoverable cost and gas transmission is not.</p> <p>Refer comments on proposal to allow Transpower to treat New Investment Contracts as Recoverable Costs.</p> <p>Agree provided (EDBs IM Draft Reasons paper):</p> <p style="padding-left: 40px;">"To recover the avoided transmission charge, the EDB would need to clearly demonstrate that it is avoiding transmission charges as a result of reducing the overall cost of supplying electricity lines services. This review would be carried out as part of the compliance regime, on a case-by-case basis."</p> <p>See comments on IRIS below.</p>

<sup>4</sup> EC presentation on draft Statement of Opportunities 2010, 21<sup>st</sup> July 2010



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	<p>innovation appears overly generous to Part 4 regulated services.</p> <p>Finally MEUG is disappointed the Commission has decided to favour Transpower compared to the regime Australian transmission companies operate under as noted in paragraph 7.8.21 of the Transpower IM Draft Reasons paper:</p> <p style="padding-left: 40px;">“Unlike the AER’s EBSS, where net efficiency losses are allowed to reduce supplier’s future opex allowance, the Commission’s proposed IRIS is not fully symmetric (as discussed in paragraphs 7.8.9-7.8.10). This means that the Commission’s proposed IRIS may skew the sharing ratio slightly more in Transpower’s favour, depending on the quantum of incremental efficiency losses carried forward by Transpower.”</p> <p>Rather than let Transpower off the hook in the present environment of large increases in capital and operating expenditure, MEUG suggests this is exactly the time when we need to have a highly disciplined environment to ensure good quality expenditure and well designed incentive schemes.</p>
Rules on DPP and information disclosure follower merger and acquisition transactions.	No view at this stage.

<p><b>Asset valuation IM for Transpower</b></p> <p>Settlement agreement RAB at 30<sup>th</sup> June 2011 becomes initial RAB on 1<sup>st</sup> July 2011.</p> <p>The RAB will adopt the Settlement approach of excluding assets not used to provide electricity lines services, works under construction, working capital, easement land planned for subsequent re-sale, New Investment Contracts (NIC) assets and System Operator assets. Intangible assets compliant with GAAP standard NZ IAS 38 can be included in RAB including finance leases but excluding goodwill.</p> <p>RAB rolled forward at depreciated historic cost less assets disposed. No indexation will be applied. Additions to RAB must have been approved by the Commission. This is consistent with the Settlement agreement.</p> <p>Straight line depreciation based on economic life of assets.</p>	<p>Agree.</p> <p>Agree apart from concern with New Investment Contracts.</p> <p>Paragraph 4.4.14 of the Transpower IM Draft Reasons Paper states:</p> <p style="padding-left: 40px;">“The Commission may review the need to include regulation around the negotiating framework for NICs applied by Transpower if this is strongly supported by submissions.”</p> <p>MEUG believe there may be a need to provide back-stop regulation and the Commission should review such a need in more detail. It is disappointing that concerns made at the Commission workshop on the NIC have not been discussed in the Draft Reasons Paper.</p> <p>Agree.</p> <p>Agree.</p>
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