Powerco Limited

CORPORATE OFFICE
84 Liardet Street
Private Bag 2061
New Plymouth
T 0800 769 372
F +64 6 758 6818
www.powerco.co.nz

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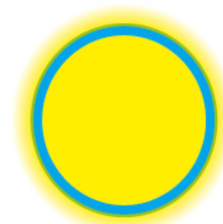
Dr Mark Berry
Chairman
Commerce Commission
PO Box 2351
WELLINGTON 6140

POWERCO



Dear Mark

Re: Cross submission on submission's made on the Commission's invitation to contribute to the problem definition for the Input Methodologies review

This is Powerco Limited's cross submission on submissions made on the Commerce Commission's 16 June 2015 discussion paper *Input methodologies review – Invitation to contribute to problem definition*.

Given the substantial volume of submissions received by the Commission, we have chosen not to exhaustively address all points raised by other submitters but rather to focus on a small number of issues that we think warrant particular attention.

Accordingly, this cross-submission responds to the following submissions:

- Major Electricity Users Group (***MEUG***), *Submission on Input Methodologies Review* (19 August 2015), and its enclosed reports:
  - Ireland, Wallace & Associates Limited (***IWA***), *Input Methodology Review – "Black's Simple Discount Rule" – a cross check on the IM Cost of Capital* (19 August 2015); and
  - New Zealand Institute of Economic Research, *Commission review of the IM's – identifying problems with current IM's* (21 August 2015);
- Sustainable Electricity Association New Zealand (***SEANZ***), *SEANZ submission to Commerce Commission input methodology review discussion paper* (21 August 2015), and its enclosed reports:
  - Carbon + Energy Markets (***CME***), *Rooftop solar PV and network tariffs: information and discussion* (June 2015);[1] and
  - CME, *Write-downs to address the stranded assets of electricity networks in the National Electricity Market: evidence and argument* (April 2015).[2]

[1] A report prepared for UnitingCare Australia. See: http://cmeaustralia.com.au/public-reports/.
[2] A report prepared for the Total Environment Centre. See: http://cmeaustralia.com.au/public-reports/.

Enclosed with this submission is a report from HoustonKemp that responds to MEUG and IWA's proposal to adopt Black's Simple Discount Rule, and also comments on SEANZ and CME's proposals regarding asset write-downs. That report forms part of our submission.

Finally, we have reviewed in draft the Electricity Networks Association's (***ENA***) cross-submission. We support the points made by the ENA in its cross-submission.

Response to MEUG submission

Form of control

MEUG submits that the form of control – i.e. a move from price to revenue control – warrants further consideration. We agree. However, MEUG also submits that a move from price to revenue control would require adjustments elsewhere in the regulatory scheme to retain "balance" and to ensure that suppliers cannot "cherry pick" the amendments that benefit them.

In its report annexed to our submission of 21 August 2015, HoustonKemp explained why there is no basis for the proposition that a move from price to revenue control should require compensating adjustments elsewhere. We refer to that report. We note further that the risk that is removed by implementing revenue control is the risk of errors in the Commission's demand forecasting. That risk:

- is not currently compensated for in the WACC, and therefore there is no reason to adjust the WACC in order to reflect the removal of this risk; and
- may result in under- *or* over-recovery of the allowable revenue (with no a priori reason for either outcome to be more likely), and therefore removing this risk does not reflect cherry-picking by suppliers.

WACC percentile estimate

MEUG has also proposed revisiting the Commission's decision to set the WACC at the 67th percentile. As we explained in our submission of 21 August 2015, given how recently the Commission has considered this issue, there is no reason to re-open it in the course of this review. No new information or reasons have been advanced that would justify reconsideration.

Comment on IWA report to MEUG

MEUG has, with reference to the annexed report from IWA, proposed that the Commission implement Black's Simple Discount Rule (***Black's Rule***) as a cross-check on cost of capital.

The report by HoustonKemp, annexed to this cross-submission, addresses this proposal in detail. In short, HoustonKemp concludes that the application of Black's Rule to regulated entities would be far from simple and, in their opinion, is unlikely to provide useful information. Moreover, IWA has misapplied the rule in concluding that it suggests that Transpower's MAR is too high. Once the error is corrected, the alleged overstatement of Transpower's MAR is substantially reduced.

Accordingly, Black's Rule is not well-suited to providing a cross-check on the regulated cost of capital because:

- its application would be information-intensive and costly;
- in practice, it would be difficult to apply with any certainty; and
- unlike the CAPM, it is an untested methodology in the regulatory context, and therefore, to the extent it suggested a different result to the CAPM, the Commission could not reasonably place any reliance on it.

Comment on NZIER report to MEUG

NZIER has produced for MEUG a report that highlights some of the potential market developments on the horizon for EDBs as a result of technology change and expected shifts in patterns of demand. We agree that technology change, and its likely disruptive effects on the electricity distribution sector, require investigation and discussion. In our submission of 21 August, we expressed the view that emerging technologies have real potential to change the way the industry operates.

However, we consider that discussion of the proposals that NZIER advances as possible solutions would be premature, given that we do not yet have a detailed understanding of the likely pace of introduction of new technologies, or exactly what implications they will have for patterns of demand and new business models. As NZIER itself acknowledges, "*there is going to be change but we are not sure when or what*".[3] The impact that disruptive technologies will have on the electricity distribution sector is a first order question that must be addressed before we move to consider whether there is any consequential need to adjust the IMs.

In our view, it is too early in the technology cycle to answer that first order question. We therefore support the view of the Smart Grid Forum that an abstract and uninformed response to the issues posed by the next generation of technology is not helpful. Accordingly, rather than using this review process to discuss implications for the IMs, we should instead use the current regulatory period to become better informed about where technologies are headed, and the impact of those technologies on network architecture and demand.

NZIER argues that there is a need to change the IMs now rather than wait.[4] However, the factors that they point to in support of that argument have not yet crystallised, and they acknowledge that there is substantial uncertainty about how the market will develop in the future. Changing the IMs now, in anticipation of future developments, the scope of which are uncertain, is therefore unlikely to materially improve the IMs, or better achieve the purposes of the Act, and may actually risk outcomes that are contrary to the purposes of Part 4 the Act, such as undermining the incentives to innovate and to invest.

We also note that the periodic section 52Y review processes are not the only opportunities to amend the IMs. If it were to become apparent in the future, after due consideration, that the IMs were not fit for purpose in light of the introduction of disruptive technologies, then it would be open to the Commission to amend the IMs under section 52X.

Furthermore, many of NZIER's suggested solutions are unconvincing and would involve a fundamental reworking of the regulatory concepts that underpin the IMs. Given the IMs have only been in force for a relatively short time, there is no reasonable case for making fundamental changes at this stage. Rather, the Commission should focus on identifying opportunities for incremental improvement within the existing conceptual framework. Spending the Commission's limited time and resources on debating the NZIER proposals, many of which are contingent on uncertain future developments, would be unlikely to lead to tangible improvements to the IMs, and would be likely to distract from other, more immediate, issues where there are opportunities for genuine progress.

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[3] NZIER, *Commission review of the IM's – identifying problems with current IM's* (21 August 2015) at [55].

[4] NZIER, *Commission review of the IM's – identifying problems with current IM's* (21 August 2015) at [4].

For example, a central theme in NZIER's report is that the risk of asset stranding due to technology change should be allocated to suppliers. For example, at various places NZIER suggests a reduction in WACC,[5] discounting of stranded assets in the RAB,[6] and allowing suppliers to charge consumers only for capacity that is actually used.[7] However, NZIER fails to acknowledge the impact this would have on suppliers' incentives to invest in their networks, particularly given that what is proposed is essentially a retrospective attempt to prevent suppliers from recovering investments already made, in reliance on a regulatory compact that was designed to ensure suppliers a fair return on capital. Adopting NZIER's proposals would be a form of regulatory opportunism, and a fundamental re-making of the regulatory compact, that is beyond the scope of the present review and which would also undermine future investment incentives. Regardless of the level of future investment in intermittent embedded generation, distribution networks will continue to provide utility to electricity consumers, and also to those that both consumer and generate electricity. It follows that the IMs need to continue to provide the right incentives for EDBs to invest to maintain and reinforce network assets (which will not always be fully utilised at any given time because of economies of scale that make investment in "lumpy" increments often the most efficient option for the industry and consumers).

NZIER also ignores the fact that, if applied on a forward-looking basis, requiring suppliers to bear the risk of asset stranding would increase suppliers' cost of capital, and therefore require consequential adjustments elsewhere in the regulatory scheme. For example, suppliers would expect to front-load their recovery through a steeper depreciation curve, or an increase in the WACC. It is therefore inappropriate to consider NZIER's proposals without acknowledging the knock-on consequences for other elements of the regulatory framework.

<u>DPP/CPP WACC alignment</u>

In response to Powerco's proposal to align the DPP and CPP WACCs, NZIER has commented that "*it is not clear to us why the difference in parameters would be the binding constraint preventing suppliers from applying for a CPP*." NZIER notes that other factors (e.g. the costs of preparing the proposal, uncertainty of outcome) would also discourage applicants. NZIER apparently fails to appreciate the very significant implications that changes in externally observed WACC parameter values can have on the financial performance of commercial network businesses. An expected reduction in financial performance caused by a transition to a CPP represents a very strong disincentive to apply for a CPP. As the Commission has noted in its problem definition paper, this has the potential to be an influential factor in supplier decision-making. We have explained in our earlier submissions that Powerco finds itself in that position.

NZIER also suggests that there is no evidence on which to assess the materiality of this issue, given they "*do not have examples from suppliers of possible CPP proposals that could have provided benefits to consumers sooner but were not advanced*". Again, Powerco finds itself in that very position, and other suppliers have also expressed similar views, demonstrating that this is a material issue.

Comment on SEANZ submission and enclosed CME reports

The principal SEANZ submission and its accompanying papers focus mainly on the form and structure of end consumer charges, how those charges are presented (e.g. with line

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[5] NZIER, *Commission review of the IM's – identifying problems with current IM's* (21 August 2015) at [8] and [59].

[6] NZIER, *Commission review of the IM's – identifying problems with current IM's* (21 August 2015) at [59].

[7] NZIER, *Commission review of the IM's – identifying problems with current IM's* (21 August 2015) at [78].

and energy prices bundled or separated) and the possibility that embedded generation (chiefly micro photovoltaic (PV) generation) may lead to asset stranding, and how this might affect the future valuation of RAB assets. The issues relating to pricing and the content of invoices are the responsibility of the Electricity Authority, not the Commerce Commission, and are outside the scope of the input methodologies. However, we note that most PV generation does not coincide with either daily or annual network coincident peak demand periods and it is the net load during those periods that investment in the capacity of network assets is designed to serve. Hence, at present, most PV generation is not stranding any network capacity. It may be that EDBs should revise their tariff structures to focus their charges more directly on peak demand periods, in order to be more cost reflective and fairer to all their customers, but this is not an issue for the IMs.

SEANZ suggests that a “tipping point” is near (presumably referring to the effect of PV on the use of EDBs’ assets) and there is a short 2-3 year window for regulatory change to be introduced (SEANZ principal submission, p.7). However, the only evidence provided in support of this view is that SEANZ’s membership has increased. We have explained in our principal submission why we believe that technological changes are unlikely to have a material impact on the use of EDBs’ RAB assets before the next DPP reset in 2020 and that, therefore, there is adequate time for a measured review of how the distribution landscape is being affected by technological developments and whether or not any consequential changes to the IMs might be required at some future date.

With respect to the April 2015 CME report accompanying the principal SEANZ submission, *Write-downs to address the stranded assets of electricity networks in the National Electricity Market: evidence and argument*, we note that, while it focuses on the Australian situation, particularly the government-owned distributors in Australia, it also suggests, partly overtly and partly by implication, that New Zealand EDBs currently have stranded assets in their RABs that should be negatively revalued in some way. The arguments supporting this view are rather convoluted – partly to do with past changes in the policies relating to asset valuation and partly to do with future and uncertain technological change. However, while the SEANZ arguments are unclear, the current regulatory compact is clear – the current WACC calculation and other elements of the regulatory framework applied to EDBs do not provide any compensation for the risk of asset stranding and, if this were to change, compensating adjustments elsewhere in the regulatory framework, including to the WACC calculation, would need to be made. It would also be wrong to make what would amount to retrospective value adjustments to assets currently in the RAB, when those values have supported past EDB expenditure decisions.

Retrospective changes of this sort to the regulatory regime represent particularly bad policy, as they undermine the confidence of regulated businesses in the regulatory framework and make it more difficult for them to justify investment to meet consumers’ needs. The accompanying HoutsonKemp report, *Comment on Select Submissions to the Commission’s Input Methodologies Review,* further expands on this point.

Importantly, as HoustonKemp points out, the WACC has been determined by the Commission on the basis of the current treatment of asset stranding risk (i.e. that stranded assets remain in the RAB). Network prices have not been set as if lines businesses are to bear the risk of asset stranding in the form of uncompensated asset write-downs.

In Australia, in response to arguments such as those raised by CME, the Energy Networks Association has carried out an analysis of the impact on consumers of asset write-downs.[8] The report points out that a regulatory commitment not to write-down

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[8] Energy Networks Association, *Written-down value? Assessing proposals for electricity network write-downs* (August 2014), available at: http://www.ena.asn.au/publications.

assets in the RAB provides the critical foundation for low cost financing of new and ongoing network investments. The Energy Networks Association concluded that, on all modelled asset write-down scenarios, the increased revenue requirements that resulted from asset write-downs exceeded the savings to consumers from avoided depreciation charges and returns on written-down assets. In other words, writing down assets in the RAB actually leads to worse outcomes for consumers.

If you wish to discuss this submission please contact Richard Fletcher, at richard.fletcher@powerco.co.nz. or on (04)978 9910, in the first instance.

Yours sincerely

Richard Fletcher
General Manager Regulation and Government Relations