MAJOR ELECTRICITY USERS' GROUP

30 November 2007

Karen Murray
Chief Adviser
Networks Performance Group
Networks Branch
Commerce Commission
By email to gas@comcom.govt.nz

Dear Karen

Submission on Draft Decisions Paper on Authorisation for Control of Powerco and Vector natural gas distribution services

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission (the "Commission") paper titled *Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd – Draft Decisions Paper* (the "Draft Decision"), dated 4th October 2007.

2. Comments on three aspects of the proposed cost of capital in the Authorisation follow.

3. First, the inclusion of debt leverage in the simplified Brennan-Lally CAPM needs to be reconsidered. MEUG made the same point most recently in our submission on Transpower's proposed administrative settlement. In that submission we stated:

> *WACC is too high by up to 0.3% as a result of the "penalty to debt" implied by the simplified Brennan-Lally CAPM. Including debt leverage as part of WACC leads to a higher WACC than the least cost option of assuming zero leverage and leaving decisions on how to finance the enterprise to the shareholder. MEUG raised this issue on 2nd December 2005 when making a submission to the Commission on the draft cost of capital guidelines when we attached a copy of a letter from Ireland, Wallace & Associates. The same point was also made by Cameron Partners in their submission of 2nd December 2005. A copy of that submission is also attached.*
>
> *WACC for setting prices should reflect the explicit acceptance of financing risks by Transpower's shareholder (note paragraph 83 in section 4.6.1 of Transpower's Explanatory Material report). WACC is simply the unleveraged cost of capital.*

4. The Ireland, Wallace & Associates letter and Cameron Partners submission noted above are both attached.

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5. Second, the choice of a WACC at the 75th percentile of the WACC distribution range remains a concern[1]. If, as the Commission argue, a higher than average WACC is needed to ensure there is no doubt the controlled entity has a strong incentive to invest, then why should the higher WACC also apply to already sunk capital? MEUG note that Powerco and Vector have already received excess returns from their sunk capital and they should not be gifted continuing excess profits on those assets by using a 75th percentile WACC.

6. For new investment the Commission believes the risk of under-investment has higher longer-term detriments to consumers than allowing excess profits to be earned and hence in the shorter term higher costs to consumers. With a WACC for new investment set at the 75th percentile delivered gas prices will be much higher than at the expected "efficient" level of P=50%. This will lead, on average, to inefficient investment decisions by manufacturers in new plant such as deferring investment, shifting to lower cost environments (eg Australia), investing in plant using other fuels or designing production processes that use less gas than is efficient. New Zealand will therefore be worse off. This effect on the consumption side has not been considered by the Commission. If it had, MEUG suggest the Commission's decision to significantly favour the gas distributors would have been tempered. A slight shift in the WACC above P=50% might then have been considered, such as a small fraction of one standard deviation, but not a significant shift to the 75th percentile.

7. Finally, MEUG appreciates Dr Lally considering the Ibbotson data on asset beta suggested by MEUG on 13th August 2004[2]. Unfortunately the reasons for the Ibbotson estimates being relatively low compared to other sources was not tracked down by Dr Lally. Some of the other asset estimates considered were also quite dated, for example the Standard & Poors 1989-1993 series had an overall (ie combined electric and gas utility estimate) of 0.33, being the highest of all the estimates and therefore raising the observed median of 0.27. Dr Lally then decided to ignore the 1998-2001 data because some have suggested the market was distorted by telecommunications, media and technology equity beta over that time, giving a revised US median beta of 0.28. Then without further evidence Dr Lally concludes an asset beta of 0.30 is appropriate. MEUG suggests:

   a) On the evidence in Dr Lally's paper, the asset beta for US utilities should be 0.28 not 0.30 and the subsequent flow onto the WACC proposed for the Authorisation should be amended; and

   b) Ideally more recent asset beta could be and should be sourced to check this conclusion, including more recent Standard & Poors and Ibbotson estimates and consideration as to the relevance of the more dated estimates. For example MEUG understands that Morning Star (have taken over Ibbotson) have published a 2007 Cost of Capital Year Book that includes a median asset beta for 10 Natural Gas Distribution companies of 0.16.

Yours sincerely

Ralph Matthes
Executive Director

Attachments:

- Ireland, Wallace & Associates Limited letter to MEUG, *Draft Guidelines: the Commerce Commission's Approach to Estimating the Cots of Capital ("Draft Guidelines)*, 2nd December 2005. This letter was attached to a MEUG submission to the Commerce Commission on the same date.
- Cameron Partners Limited letter to the Commerce Commission, Cost of Capital, 2nd December 2005

[1] MEUG last raised concerns on this and other assumptions favouring the line companies in our submission of 13th August 2004 following the Gas Control Inquiry conference
[2] Dr Martin Lally, *The Weighted Average Cost of Capital for Gas Pipeline Business*, 3 September 2007, table 3, p51