



MAJOR ELECTRICITY USERS' GROUP

13 March 2014

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By email to regulation.branch@comcom.govt.nz

Dear Brett

Views on whether to review or amend the cost of capital input methodologies

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission paper "Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies" dated 20th February 2014.¹
2. We asked the New Zealand Institute of Economic Research (NZIER) for comments on the paper, and specifically questions five and six. A memorandum from NZIER dated 13th March 2014 is attached and should be read as part of MEUG's submission.
3. Franks & Ogilvie have also considered the Commission's statutory power to determine when to amend the Input Methodologies (IM). Their advice is that under circumstances where the Commission is on notice that an IM is inconsistent with the purpose to Part 4 and/or s 52R of the Act, and the inconsistency has a material and persistent effect, the Commission probably has an enforceable duty to exercise the amendment power.
4. Members of MEUG have been consulted in the preparation of this submission. This submission is not confidential.
5. The difference in the individual and default price-quality paths to be set 1st April 2015 will be materially different as between WACC set at the 75th percentile and mid-point. Based on the 2010 IMs, this "uplift" will be approximately 0.73%. We have estimated that when the uplift is applied to \$15 billion of assets, the additional charges to consumers are approximately \$150m per year. These are material amounts. They reinforce the need to ensure that intriguing but abstract finance theory is not unduly elevated. It should not mask or negate real world observations and their impact on consumers. It is particularly important to weigh the risk of sustained and ongoing significant excessive returns on the whole regulatory asset base (RAB) over expectations from a true WACC mid-point, against the capital investment that, it is claimed, needs to be "incentivised".

¹ Document URL <http://www.comcom.govt.nz/dmsdocument/11510> found at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/further-work-on-wacc/>

6. The scale of future capital expenditure can be observed in financial disclosures. For example Vector plans expenditure on network assets of \$154m in 2013/14². This planned capital expenditure is 6.1% of the closing RAB³ at 31st March 2013, of \$2,536m. An estimate of net new capital spending planned by Vector for 2013/14 can be approximated by netting of depreciation of \$85m (assuming the same as for 2012/13⁴) to give a value of \$70m (\$154m - \$85m). This estimate of net new capital expenditure is equal to just 2.7% of the RAB. The current "uplift" of 0.73% on Vector's RAB of \$2.5 billion constitutes an enormous incentive for a disproportionately small amount of net new capital expenditure of \$70m.
7. Responses to each question in the Commission's paper follow.

Question 1: Are the positive incentives provided by using the 75th percentile now weakened?

8. The Commission considers the midpoint to be the best estimate of the likely true WACC for the regulated suppliers and its choice of the 75th percentile estimate for price-setting purposes was a deliberate decision to over-estimate the likely WACC⁵.
9. MEUG does not accept that the 75th percentile uplift for excessive profits is necessary or that the purported incentive is "positive" for efficient investment. The High Court too was sceptical of the claimed linkage between guaranteed excessive returns and incentives both as a matter of logic and in the absence of a proper evidential foundation⁶.
10. There is no evidence from which to gauge the relative importance of the excess return prospects in influencing investment plans, in comparison with other influences or incentives. However, there is reason to consider that the excess return prospects may be immaterial as a driver of necessary (efficient) investment, despite their very high costs for consumer. Other incentives or decision factors include, for example:
 - a) requirements to invest to maintain mandatory quality standards under price quality paths because failure to do so might impose a higher regulatory burden reducing returns to line owners;
 - b) the relative importance of volatility in unders and overs arising from chance, depending on the reset dates of regulatory periods and in particular, the risk-free rate prevailing at the time;
 - c) the assurance of keeping gains from efficiency (cost reductions) within regulatory periods;
 - d) other constraints on timing such as seasonal factors, planning, resource availability, coordination.
11. The Commission may get evidence on such matters during consultation. If a case in favour of uplift can be established empirically, uncertainty will remain until that exercise is undertaken. The IMs must maintain intellectual coherence to engender market confidence

² Refer Vector, Asset Management Plan, 2013-2023, document URL

http://www.vector.co.nz/sites/vector.co.nz/files/Electricity%20Information%20Disclosure_0.pdf found at <http://www.vector.co.nz/corporate/disclosures/electricity/electricity-asset-mgmt>

³ Refer EDB Information Disclosure requirements, information templates for disclosure year ended 31 March 2013, Schedule 4, prepared 14-May-13, document URL

http://www.vector.co.nz/sites/vector.co.nz/files/Vector_electricity%20information%20disclosures%202013%20sch%201%20to%202010.pdf found at <http://www.vector.co.nz/corporate/disclosures/electricity/electricity-financials>

⁴ ibid

⁵ *Wellington International Airport Ltd and others v Commerce Commission* [2013] NZHC 3289, at paragraphs [1433] and [1451] to [1452] ("High Court Decision"); Commission's written submissions dated 6 August 2012, volume 2: Cost of Capital Part A, 6 August 2012, at paragraph [768].

⁶ High Court Decision at [1479] and [1482]

and certainty. The Court's criticisms of the assumptions and theory underpinning the use of the 75th percentile in place of the likely true WACC estimate erode that coherence. Until remedied, these doubts will continue to undermine the credibility of the cost of capital IM and cause supplier and end consumer investor uncertainty.

12. The Commission has identified one example of the market taking account of the High Court criticisms and the Commission's indication that it may amend the WACC range before the next price-quality path resets. Last month, in an independent valuation of Vector Limited, Macquarie Private Wealth considered it more likely than not that the Commission will cease to use the 75th percentile uplift⁷. If the Commission does not amend the WACC range this year, there must be a full review of the IMs by 2017. It is likely that from now until then, the market will factor in the probability of a reversion to the midpoint - at least for returns earned post 2020. In the event the Commission does not urgently amend the WACC IM, there may be a minor certainty gain for investors (ie the window between the end of the court process and 2017) but unless MEUG's appeal to the Court of Appeal is successful, consumers will continue to pay excessive returns until at least 2020.
13. It follows that any purported "incentive" is now significantly diminished and cannot act as a sufficient counterweight to the Commission's statutory imperative to limit excessive returns. The High Court gave the Commission a very clear steer that the current cost of capital IM is inconsistent with both the purpose of Part 4 in s 52A of the Act and the purpose of IMs under s 52R. The Commission's responsibility for the administration of Part 4 requires it to undertake an urgent amendment as soon as possible. Franks & Ogilvie's advice, which accompanies this submission, addresses the Commission's responsibility from a legal perspective.

Question 2: Should we do a review of the cost of capital IMs early?

14. The Commission has stated that a full review would not be possible in time for the price-quality paths due to be reset in 2015, but an amendment could be.
15. The High Court's emphatic validation of most of the cost of capital IM makes a full review ahead of schedule unnecessary. The Court:
 - a) upheld the cost of equity and debt parameters chosen by the Commission⁸;
 - b) upheld the Commission's estimates of the standard error of individual parameters⁹;
 - c) upheld the Commission's selection of parameters at the high range to allow for imprecision and uncertainty¹⁰;
 - d) found there to be no basis for making an upwards adjustment for alleged model error/bias and upheld the Commission's decision not to allow for one¹¹;
 - e) found there to be no basis for including ex ante compensation for asymmetric risk in the cost of capital IM¹²; and
 - f) adopted the Commission's cross-checks (which verified that both the midpoint and the 75th percentile fell within a reasonable range)¹³.

⁷ Macquarie Private Wealth, Vector, ComCom swerves off piste, 7 February 2014, page 1, referenced in the Commission's Invitation to Review at footnote 35.

⁸ High Court Decision [1287], [1288], [1343], [1383], [1387], [1547] and [1657]

⁹ High Court Decision [1421]

¹⁰ High Court Decision [1458]

¹¹ High Court Decision [1711] - [1713]

¹² High Court Decision [1746]

¹³ High Court Decision [1228]

Question 3: Should we consider an amendment solely to the 75th percentile?

16. It is possible to amend the WACC range without disturbing the balance struck both within the cost of capital IM itself or in its interrelationship with other IMs. There is also no obvious tension with the way the Commission determines or has determined price-quality paths.
17. As set out in the previous answer, the High Court upheld all other relevant parts of the cost of capital IM and would have done so even if the midpoint WACC was used for price-quality paths. None of the Court's findings in respect of the appeals against the cost of capital IM or any other IM under appeal, were conditional upon the use of the 75th percentile for pricing purposes. Even within its consideration under Part 6.11 of the 'Cost of Capital Range', the Court was careful to determine first that the expected WACC (i.e. the mid-point estimate) was free from bias before considering, quite separately, whether the 75th percentile uplift was necessary or consistent with the purpose of Part 4.
18. The Commission can confidently amend the WACC range without fear of creating an internal inconsistency within that IM.
19. The current IMs will continue to apply to Transpower's IPP and the EDBs' DPP until they are reset, unless the IMs materially change as a result of a court appeal.¹⁴ The Commission will reset both price-quality paths this year, with the next regulatory period due to begin on 1 April 2015.
20. Orion is subject to a customised price-quality path. Orion's CPP applies until 2019, after which Orion will be subject to the prevailing DPP unless another CPP is determined. In the meantime, Orion's CPP will be unaffected by a review of the WACC range by the Commission as it cannot be reset unless the WACC range changes as a consequence of a court appeal.
21. In its determination of Orion's CPP, the Commission disallowed ex post compensation for actual reduced demand. Its primary reason was because the risk was non-systematic and was capable of being minimised by investor diversification¹⁵.
22. The Commission made a passing observation that the 75th percentile may be a buffer against demand risk, although also pointed out that this was not a reason for using the 75th percentile¹⁶. This comment was perhaps primarily intended as an invitation to suppliers to consider the overall generosity of the WACC formula in the context of the Orion CPP decision. Whatever the reason, an uplift is inconsistent with the Commission's own reasons for denying demand risk compensation and lacks an evidential foundation. The 75th percentile is not a necessary buffer against demand risk and this factor should not affect the Commission's decision whether to amend the cost of capital IM.

¹⁴ S 53 Commerce Act 1986

¹⁵ Final decision for setting the CPP of Orion New Zealand Ltd dated 29 November 2013, paragraph C5.1, also C23.2.1 and footnote 265

Question 4: Are there any other options for addressing the Court's concerns?

23. None that MEUG is able to offer.

Question 5: What evidence is there in support of either the 75th percentile or credible alternatives?

24. This question is considered by NZIER in its expert advice attached.

Question 6: In selecting an appropriate WACC percentile, how significant is it that regulated outputs are inputs to other sectors of the economy?

25. This question is considered by NZIER in its expert advice attached.

Conclusion

26. The intended investment incentive to overcome perceived asymmetric social costs has been negated by uncertainty since the High Court decision. That is reason enough to go through the amendment process, because the uplift has no other justification. The Commission has responsibility to ensure that IMs are consistent with the purpose of Part 4 and under s 52R. The power to amend parts of an IM independently of a full review was clearly intended to cover the current situation. We would go so far as to say that the Commission has a clear duty to amend under such circumstances.
27. The Commission should issue a notice of intention to amend the cost of capital IM by deleting the uplift and replacing it with the midpoint WACC. This is an appropriate starting-point because:
- a) Enhancing incentives to invest with excess returns is justified only by putative asymmetric social cost;
 - b) The assumption of asymmetry in social cost is supported only by theory;
 - c) The theory has not been well tested;
 - d) Even if it has some validity, it is unlikely to apply universally – there will be sectors and products and services that are intermediary, for example, where the elasticity of demand or substitution invalidates the assumption of greater social cost to non-investment than to inefficiently high returns. Indeed the asymmetry could be reversed;
 - e) There is no evidence in the energy sector that the uplift;
 - i) Is necessary to secure the investment that has been made
 - ii) Is necessary to secure desired levels of future investment
 - iii) Has not induced excessive investment
 - iv) Has affected investment decisions at all
28. The foregoing are all matters capable of being tested during consultation. In the absence of materially different information from what is known at present, the default position should be to remove the uplift from the cost of capital IM.

Contact details to discuss these submissions

29. Please contact NZIER directly if you wish to discuss any part of their expert advice or call me for clarification of any other part of this submission.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. Matthes', with a long horizontal stroke extending to the right.

Ralph Matthes
Executive Director

Attachments:

- NZIER note to MEUG, WACC uplift preliminary advice, 13th March 2014
- Franks & Ogilvie, letter to MEUG, Is the Commerce Commission obliged to amend or review the cost of capital input methodology? 13th March 2014