MAJOR ELECTRICITY USERS' GROUP

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

Dear Brett

Submission on proposed amendment to WACC percentile

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission paper[1] "Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services", dated 22th July 2014 (the "Commission's Proposal Paper").

2. MEUG sought expert independent advice from the New Zealand Institute of Economics (NZIER) and Ireland, Wallace & Associates (IWA). Those two reports are appended separately and form part of this submission. Those reports are:

   - NZIER "Changing the WACC percentile, advice to MEUG regarding Commerce Commission proposal to amend the regulatory WACC for electricity line & gas pipeline services" 29th August 2014 ("the August 2014 NZIER report"); and
   - IWA "Commerce Commission, Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services 22 July 2014, Report to Major Electricity Users' Group", 29th August 2014 (the "IWA report").

3. Members of MEUG have been consulted in the preparation of this submission. This submission is not confidential.

This is a material issue

4. Many tens of millions of dollars per year of line charges payable by customers of electricity depend on the Commission's decision on the WACC percentile.

5. The table below summarises the impact of not using the mid-point WACC and adding an uplift to the 67th percentile, taking another step from then 67th to the 75th percentile and

[1] http://comcom.govt.nz/regulated-industries/electricity/electricity-default-price-quality-path/default-price-quality-path-from-2015/ document http://comcom.govt.nz/dmsdocument/12079

summing those steps to demonstrate the difference between the mid-point and the 75th percentile:

Impact of different WACC percentiles on charges to electricity line company customers				
	Increase in line charges in 2015/16	NPV of increased line charges RCP2	Annual price change as a fraction of:	
	$m pa	$m	Forecast 2014-15 revenue	Forecast 2014-15 opex
Increasing from mid-point to 67th percentile	92.6	384.3	3.6%	12.1%
Increasing from 67th to 75th percentile	49.0	203.4	1.9%	6.4%
Total increase mid-point to 75th percentile	141.7	587.6	5.4%	18.5%

6. Any uplift relative to the mid-point WACC increases line charges paid by customers of line companies. The table summarises the effect of different percentiles relative to the mid-point. The Commission's Proposal Paper proposal is to use the 67th percentile. MEUG estimates that will add up to $92m in line charges in 2015/16 and over the 5 year Regulatory Control Period 2 (RCP2, 2015-20) have an NPV additional cost of $384m.

7. To give an idea of the scale of the annual increase the last two columns of the table note a $92m increase in line charges in 2015/16 is equivalent to an increase of 3.6% on forecast total line revenues or a 12% increase in operating costs. These illustrate that the change in line charges are significant.

8. Similarly the bottom two rows of the table summarise the change for the next step from the 67th to 75th percentile and then the total effect of a mid-point to 75th percentile.

9. Appendix 1 contains the detailed calculations.

Response to Commission's Proposal

10. The August 2014 NZIER report, the IWA report and the above estimate of the materiality of what's at stake provide the detail for the Commission to support the summary comments that follow. The comments are ordered to match the section headers in the Executive Summary of the Commission's Proposal Paper (paragraphs X3 to X25):

"We have reconsidered the WACC percentile following the High Court's IMs judgment"

11. MEUG acknowledge the Commission has undertaken a very transparent and inclusive process under tight timeframes.

12. All consumers are likely to agree with MEUG's appreciation of the effort by the Commission and the industry as a whole given the materiality of the cost impost of up to $142m pa if the 75th percentile is retained at 1st April 2015 rather than changing to the mid-point.

"We have gathered significant new evidence in response to the Court's judgement"

13. Evidence is always useful though:

    a) Some evidence is more useful than other evidence; and

    b) Care should be taken to separate robust evidence from theoretical analysis, which is essentially opinion masquerading as evidence.

14. The RAB multiple and other evidence pertaining specifically to the New Zealand energy market at this time fall into the former category. The Oxera analysis, which is based on assumptions that are not truly reflective of the relevant market, falls into the latter.

15. The RAB multiple analysis in the Commission's Proposal Paper is useful evidence that the regulatory WACC set at the 75th percentile exceeds the true market WACC. That finding corroborates the view of the High Court. The IWA report provides a more detailed RAB multiples analysis along with well proven approaches to calculate Market Value Added. IWA's analysis demonstrates that the Commission's estimates of RAB multiples probably underestimate the real multiples expected by sophisticated equity investors. The RAB multiple analysis does not provide the Commission with evidence to support an uplift above the mid-point WACC. It does, however, support the Commission's view (and the Court's warning) that setting WACC above the mid-point would likely lead to suppliers earning excess returns. The analysis also creates significant doubt that any uplift to the best estimate (midpoint) WACC is necessary to incentivise investment now or in the foreseeable future.

16. It goes further. It strongly suggests a persistent regulatory bias of error associated with the regulatory WACC, but in the wrong direction. The empirical evidence suggests that it is so generous the primary regulatory concern now should be to find ways to mitigate the extraction of excessive profits, to reinstate normal return pressure for innovation, and to protect the dynamic efficiency of users that depends on pricing consistent with the pricing that would emerge in workably competitive markets.

17. The August 2014 NZIER report explains in detail why the Oxera analysis does not meet the standard of evidence to be relied upon to estimate an uplift above the mid-point.
In particular, the NZIER finds that the working assumptions adopted by Oxera fail to reflect the real world conditions operating in the NZ energy transmission and distribution markets. NZIER has also compared Oxera $1 billion guestimate of potential welfare loss against targeted loss load analysis carried out in New Zealand market in 2012. It suggests the Oxera estimate could overstate loss by as much as 1000%.

"Judgement is required when determining the appropriate WACC percentile"

18. With the only empirical evidence suggesting that the regulatory bias of error in current settings is likely to be permitting excess returns MEUG sees no reason why the Commission should use un-quantified discretion or judgement to give effect to a belief there must be a reflection of adviser opinion in favour of a pre-cautionary uplift in WACC above the mid-point. That is what got the Commission to the 75th percentile in the first place, and was why its approach was criticised by the High Court. No evidence; no uplift.

19. The Commission's Proposal Paper cites primarily the analysis by Oxera to justify a likely range for a percentile uplift then chooses the 67th percentile being half-way between the 60th and 75th boundaries. The August 2014 NZIER report significantly undermines the Oxera study. Oxera's analysis is abstract and fails to reflect the New Zealand situation. The Commission simply cannot rely on its report as justification for an uplift. NZIER itself has concluded that "at this time we see little evidence that suggests a WACC other than the mid-point should be used by the Commission."

20. NZIER also discuss future areas for research to dovetail with the IM resets to be completed in 2017. Those initial views build on the New Zealand specific evidence for EDB and Transpower's actual versus planned capital expenditure and trends in quality over time. The Commission's advisors and the Commission recognise that EDB and Transpower make investment decisions on a range of factors and the relationship between those needs investigation. But that is not a reason to fall back on a guess that an uplift is needed. The August 2014 NZIER report demonstrates that New Zealand has sufficient reliability headroom with recently invested capital, coupled with modest demand growth over the next

years. Under these conditions, anything other than the mid-point WACC is unsupportable. The setting of IMs is an iterative process (as the High Court emphasized in its decision declining leave to appeal to the Court of Appeal) and there is a full review due in 2017. If circumstances change between now and then, the Commission can take fresh evidence into account in its redetermination.

21. It is revealing that in all the submissions this year no line monopoly has given an example of a capital expenditure investment since 2010 that would not have been undertaken had the mid-point WACC been in place.

22. On the other hand, consumers can give clear evidence to the Commission of the increase in line charges they are forced to pay due to the uplift. At the proposed 67th percentile the Commission knows for sure the cost to consumers relative to the mid-point WACC. The RAB multiples confirm that these costs likely flow back to suppliers as excess profits. The Commission must ensure that it has concrete evidence of offsetting benefits to consumers before it sanctions excessive costs of$92m pa relative to the mid-point WACC.

"The 67th percentile WACC is appropriate for price-quality path regulation"

23. As discussed above the evidence in the August 2014 NZIER report and the IWA report, along with the materiality of the issue at stake, lead to a contrary conclusion. In the absence of empirical evidence supporting an uplift, the mid-point best estimate WACC remains the only evidence based option.

24. MEUG note that the Commission has characterised the proposed amendment as a change from the 75th to the 67th percentile. Reading off the table in paragraph 5 above; this change results in a decrease in line charges paid by electricity consumers on 1st April 2015 of $49m. That is a mis-characterisation of the Commission's proposal. The High Court and the Commission agree that the starting point is the mid-point, with any claim of asymmetry of consequence from an inaccurate WACC subject to proof. The counterfactual to the proposal in the Commission's Proposal Paper is therefore the mid-point not the 75th percentile. The draft determination would result, not in a saving in line charges to consumers; but rather in a cost of up to$92m pa.

Next steps

25. We look forward to viewing and commenting on the submissions of other parties.

Yours sincerely

Ralph Matthes
Executive Director

Appendix: Impact of different WACC percentiles on charges to electricity line company customers

Post-tax WACC as at Jul-14[2]:		step change	
Mid-point (50th percentile)	6.10%		
67th percentile	6.57%	0.47%	Increase 50th to 67th
75th percentile	6.82%	0.25%	Increase 67th to 75th
		0.72%	Increase 50th to 75th

Electricity line monopoly	RAB [3, 4] $m	14-15 f/cast Rev [5] $m	14-15 f/cast opex [6] $m
Transpower	4,700	950	265
EDB	9,456	1,658	499
Total	14,156	2,608	764

	Increase in line charges in 2015/16 [7] $m pa	NPV of increased line charges RCP2 $m	Annual price change as fraction of: Forecast 2014-15 revenue	Forecast 2014-15 opex
Impact of change from 50th to 67th				
Transpower	30.8	127.6	3.2%	11.6%
EDB	61.9	256.7	3.7%	12.4%
Total electricity line monopolies	92.6	384.3	3.6%	12.1%
Impact of change from 67th to 75th	0.0	0.0	0.0%	0.0%
Transpower	16.3	67.5	1.7%	6.1%
EDB	32.8	135.8	2.0%	6.6%
Total electricity line monopolies	49.0	203.4	1.9%	6.4%
Impact of change from 50th to 75th	0.0	0.0	0.0%	0.0%
Transpower	47.0	195.1	5.0%	17.8%
EDB	94.6	392.5	5.7%	19.0%
Total electricity line monopolies	141.7	587.6	5.4%	18.5%

[2] CC spreadsheet titled "RAB-multiples-Analysis-for-WACC-percentile-draft-decision.xls" posted on web site 24th July 2014. Worksheet "Formula to estimate WACC", web http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/further-work-on-wacc/

[3] Transpower RAB per Transpower's memo "2015/16 to 2016/20 Transmission Revenue, July 2014", web https://www.transpower.co.nz/about-us/industry-information/revenue-and-pricing

[4] EDB RAB per CC, Electricity summary database for March 2013 information disclosures spreadsheet, 3rd December 2013, Data for Regulatory Investment Value for year ended 31st March 2013, web http://www.comcom.govt.nz/regulated-industries/electricity/electricity-information-disclosure/electricity-information-disclosure-summary-and-analysis/summary-and-analysis-of-information-disclosed-in-march-2013/

[5] Transpower revenue f/cast same source as footnote 3. EDB revenue f/cast same source as footnote 4.

[6] Transpower opex f/cast from CC, Setting Transpower's individual price-quality pat for 2015-2020, Reasons for draft decision, 16th May 2014 (table X3, p8). EDB opex f/cast same source as footnote 4.

[7] Estimated change in line charges = (RAB * change in post-tax WACC) / (1-company tax). The product of RAB * change in post-tax WACC is the change in post-tax income the monopolist receives. To estimate the pre-tax charges payable by consumers gross this product up by the corporate tax rate.