



# MAJOR ELECTRICITY USERS' GROUP

29 August 2014

Brett Woods  
Senior Analyst  
Regulation Branch  
Commerce Commission

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

Dear Brett

## **Cross-submission on proposed amendment to WACC percentile**

1. This is a cross submission by the Major Electricity Users' Group (MEUG) on the submissions of other parties to the Commerce Commission paper "Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services", dated 22<sup>th</sup> July 2014 (the "Commission's Proposal Paper"). Submissions closed 29<sup>th</sup> August 2014<sup>1</sup>. A list of MEUG members is set out in the appendix.
2. MEUG sought expert independent advice from the New Zealand Institute of Economics (NZIER) and Ireland, Wallace & Associates (IWA) and Franks & Ogilvie (F&O) in preparing this cross-submission. The advice of those experts is appended separately and form part of this submission. Those reports are:

- NZIER "The WACC uplift question, a brief review of the balance between intuition and evidence supporting the WACC uplift", 12<sup>th</sup> September 2014.
- IWA "Commerce Commission's proposed amendment to the WACC percentile for Electricity Lines Services and Gas Pipeline Services dated 22 July 2014 – Report to Major Electricity Users' Group for cross submission" 12<sup>th</sup> September 2014.

And attachment, Simmons Corporate Finance, Horizon Energy Distribution Limited, Independent Adviser's report in respect of the partial takeover offer by Marlborough Lines Limited, October 2009. This report is enclosed within a Horizon Energy report, Target Company Statement, dated 13<sup>th</sup> October 2009.

- F&O "Specific Legal Issues Arising from Submissions" 12<sup>th</sup> September 2014

We previously submitted a cross-submission comprising an NZIER report of 9<sup>th</sup> September circulated to all parties and the Commission on 10<sup>th</sup> September.

---

<sup>1</sup> Submissions and the Commission proposal paper found at <http://comcom.govt.nz/regulated-industries/input-methodologies-2/further-work-on-wacc/>

3. The Commission's work followed a request by MEUG along with Consumer NZ and Employers and Manufacturers Association (EMA) Northern to undertake a review on 19<sup>th</sup> December 2013. The issues commented on in that letter are all relevant and important supporting material to MEUG's submission two weeks ago and this cross-submission. The same applies to all of MEUG's submissions on the WACC percentile this year including expert advice prepared for MEUG. Rather than append those to this letter they are listed in a footnote<sup>2</sup>.
4. Members of MEUG have been consulted in the preparation of this submission.
5. Several non-MEUG member companies, listed in the appendix, have also been consulted and agree with this cross-submission in support of a mid-point WACC rather than the 67<sup>th</sup> percentile WACC.
6. Some MEUG members will be making additional supporting cross-submissions.
7. This submission is not confidential.

#### **This remains a material issue**

8. There was scant evidence or analysis in the submissions of other parties to alter MEUG's submissions of 29<sup>th</sup> August 2014 that this is a material issue in terms of higher line charges that customers of line services will have to pay. Most submissions treated the effect on consumers as an academic debate as part of the question on the welfare standard<sup>3</sup>. That forgets the core purpose of regulating monopolies is about the welfare of consumers. It's the impact on individual consumers that other submitters fail to grasp.
9. Many submitters say in different ways that asymmetric social costs of underinvestment justify the uplift. Few go much further than repeating that it is a widely shared assumption. Oxera and some who comment directly on the Oxera work endeavour to show that the losses assumed to be avoided might exceed the cost of expected excess returns.
10. But none do what NZIER has done to show how to quantify both assumed losses, and the level of excess return that may be entirely unrelated to inducing investment that would reduce such losses. MEUG suggests that there is limited value in submissions that talk about the benefits from reduced asymmetric social costs to consumers of paying at a WACC above the mid-point without any real world based avoided cost estimates to compare with the knowable higher line charges.
11. MEUG's submission estimated this could be up to \$92m per year. Given the absence of engagement in the submissions with this critical issue MEUG has, in the next two paragraphs, estimated what this cost means for average household, commercial and industrial end user's to give more perspective to the impact on actual consumers.

---

<sup>2</sup> Relevant and supporting this cross-submission and MEUG submission and expert advice of 29<sup>th</sup> August are the following all addressed to the Commerce Commission:

- Consumer NZ, Employers and Manufacturers Association (EMA) Northern, and MEUG letter "Energy Prices and Urgent Review of Cost of Capital Input Methodology" 19<sup>th</sup> December 2013
- MEUG submission, "Views on whether to review or amend the cost of capital input methodologies", 13<sup>th</sup> March 2014 and
  - ~ NZIER, "WACC uplift: preliminary advice", 13<sup>th</sup> March 2014.
- MEUG submission, "Evidence on WACC percentile", 5<sup>th</sup> May 2014, and
  - ~ NZIER, "Review of evidence in support of an appropriate WACC percentile – Response to Commission invitation of 31 March 2014", May 2014.

<sup>3</sup> For example CEG, Economic Review of draft decision on the WACC percentile, a report for NZ Airports, August 2014, pp 16-18

## 12. MEUG estimate of the impact on an average household follows :

Impact on households of up to a 3% increase in WACC changing from mid-point to 67 <sup>th</sup> percentile	Average demand per household	Number of households	Average price (including GST) as at March 2014		Effect of WACC increase	
			kWh pa	number	c/kWh	\$ pa
Household data	7,760	1,683,089				
Average cost pa:						
• Energy			16.39	1,272		
• Line			11.19	869	\$26/house	\$44m
• Total			27.59	2,141		
Notes:						
1. Average prices from Ministry of Business Innovation and Enterprise Energy (MBIE) sales-priced residential prices Mar2002-Mar2014						
2. Average demand per household and number of households from MBIE Energy Data File as at end March 2011						
3. Increase in line charges of 3% due to increase in WACC from mid-point to 67 <sup>th</sup> percentile as estimated by MEUG, 29 <sup>th</sup> August 2014						

## 13. MEUG estimate of the impact on an average commercial and industrial users follows:

Impact on non-households of up to a 3% increase in WACC changing from mid-point to 67 <sup>th</sup> percentile	Data for March 2011 only. More recent data not available.			
	Annual demand	Average line charges (before GST)		Additional cost for up to 3% increase in WACC
	MW pa	c/kWh	\$ pa	\$ pa
Commercial	63	5.19	3,261	\$98/user
Industrial (selected)	184	3.28	6,025	\$181/user
Notes:				
1. The above values are likely to be an understatement because the last MBIE published data for non-household price and demand relates to March 2011.				
2. The commercial and industrial sectors exclude Agriculture, forestry and fishing sectors.				
3. The industrial sectors in the above table are a selection that excludes data for ANZSIC C214 Basic non ferrous metals, ANZSIC C211 Basic Ferrous metals and ANZSIC C15 Pulp, Paper and converted paper products, ie have removed all sectors with large aluminium, steel and large pulp and paper manufacturers.				

## 14. There are three observations:

- For households the annual cost per household is \$26 per year. However over all residential ICPs the cost is significant at \$44m per year. This is just less than half the total impact on all users of line services of \$92m even though households use approximately a third of total annual demand. The proportionately higher cost on household is because they use more of the low voltage network than larger customers.
- The average cost for the above non-household users' is small because most of the 180,000 commercial and industrial businesses with ICP's in New Zealand are very small.
- The few hundred largest electricity users' are also large employers and creators of a large proportion of GDP. Those companies pay in excess of \$1 million per annum and in some cases in excess of \$10m per annum in electricity line charges.

Enterprises paying \$1m in line charges will incur additional costs of up to \$30,000 per year if the 67<sup>th</sup> percentile WACC is used rather than the mid-point WACC. For companies paying \$10m in line charges the additional cost will be up to \$300,000 per year. Additional costs of \$30,000 to over \$300,000 per year for the largest few hundred electricity users' will affect their competitiveness and ability to invest in new capital, processes and people.

When MEUG advised several non-MEUG member companies of the value at stake in the decision on the WACC percentile they were astounded. They were all the more amazed when we said no evidence had been placed before the Commission unequivocally showing an offsetting benefit to this knowable increase in charges.

### Response to submissions of other parties

15. Submissions can be categorised into three groups:
  - a) Users' of monopoly services. Submitters were Air NZ and BARNZ. Both supported the mid-point. MEUG agrees with those submissions;
  - b) Parties that pass through line charges. There was only one submitter, Meridian Energy, supporting the draft proposal for the 67<sup>th</sup> percentile; and
  - c) Monopolies that all favoured retention of the 75<sup>th</sup> percentile.
16. This cross-submission focuses on the latter. The monopolies submitted on a range of matters many of which can be described as red herrings and not relevant to the decision on the WACC percentile. For example:
  - a) Asymmetric cash flow risks and treatment of catastrophic events:
    - ~ CEG, Economic Review of Covec Report, for NZ Airports Association and ENA (pp 23-24)
    - ~ Incenta for ENA (pp16-17)
    - ~ HoustonKemp for Powerco (pp 11-12).
  - b) Differences of opinion on CAPM and parameter values used for mid-point estimates:
    - ~ HoustonKemp for Powerco (pp 6 -10).
17. The submission issues MEUG considers particularly relevant to the Commission decision are:
  - Is there any change in the RAB multiplier analysis?
  - What is the most likely import of RAB multiples which are all positive, and mostly substantial, in considering whether the regulatory WACC is above the true cost of capital?
  - Is there any additional evidence in submissions to support a percentile above the mid-point?
  - Is the decision criteria consumer welfare or total welfare? To what extent may the Commission continue to apply criteria drawn from total welfare analysis, when the legal test is consumer welfare?
  - Is there a credible loss function analysis which is more than abstract speculation?
  - If so how probative is it in comparison with conclusions drawn from less theoretical information?

- Is there an uplift point above the WACC range mid-point or best estimate, which is not simply unanchored generosity without reference to the statutory purposes, and probably conflicting with them?

These are discussed briefly in the following sections as a guide to where the expert advice of NZIER, IWA and F&O can assist the Commission.

**Is there any change in the RAB multiplier analysis?**

18. The answer is yes.
19. MEUG asked IWA to consider responding to other submitters that argued the Commission could not rely on or had miss-analysed the RAB multipliers. There was no evidence in the submissions for IWA to amend their advice of 29<sup>th</sup> August and so IWA have focussed on elucidating further evidence to rebut critics that said there were too few observations.
20. The IWA cross-submission report attached comprises an analysis of Horizon Energy and the sale of 51% share of OtagoNet Joint Venture by Marlborough Lines to its minority JV partners. IWA find RAB multiple ranges of between 1.3 to 1.4 and 1.3 to 1.7 (depending on control premium) respectively).
21. This supports the case that at the current 75<sup>th</sup> percentile WACC the monopolies expect to earn well above the actual market expected WACC.

**Is there any additional evidence in submissions to support a percentile above the mid-point?**

22. The answer is no.
23. The NZIER cross-submission finds no new expert evidence to change their view in advice of 29<sup>th</sup> August 2014. In the summary section of the NZIER report attached they state (paragraph 66)

“This brief cross-submission has confirmed for us that the debate about what constitutes evidence regarding WACC uplift, and the lack of empirical evidence to support uplift.”

**Is the decision criteria consumer welfare or total welfare?**

24. The answer is consumer welfare.
25. The Franks Ogilvie advice, endorsing and expanding on the BARNZ submission, is unequivocal. The consumer welfare interest prevails, and it is not subsumed into, or equivalent to a total welfare approach.

**When is there sufficient evidence; or if not the role of judgment?**

26. Any Commission willingness to offer what Franks Ogilvie refers to as ‘prophylactic generosity’, runs into the problem that suppliers are known to commit to investment for WACC returns that are below the regulatory WACC. That RAB multiple evidence is supplemented by other evidence about investment decisions available to the Commission, MEUG’s submissions in 2009 and 2010 referred, for example, to Transpower’s admission that it would have made the investment decisions it made irrespective of the outcome of the regulatory WACC setting process.

**Closing comments**

27. Debate on whether an uplift or percentile greater than the mid-point has been considered by this Commission and the High Court for at least six years. In our view we are with the help of evidence, or lack of, able to say for sure only the mid-point is defensible.
28. MEUG members and all end consumers will not want to "shoot ourselves in the foot" by having a regulated WACC that will put future reliability of line services at risk. Any inference that we will be satisfied by anything other than the mid-point fails to understand our position.
29. For example Professor Ingo Vogelsang in commenting on the Commission's proposal said<sup>4</sup>:

"The reduction in the WACC uplift from the 75<sup>th</sup> to the 67<sup>th</sup> percentile is unlikely to materially affect investment but will relieve consumers."
30. On the one hand literally it is true there will be "relief" for consumers by way of lower line charges. Vogelsang though is silent on what the correct counterfactual is. It is against that measure consumers will assess if they feel relief or disbelief. Nothing in the submissions of other parties has changed our view the counterfactual is the mid-point. In that case any decision for a percentile greater than the mid-point will lead to both disbelief by consumers and undermine confidence in the regulatory regime to the extent intuition rather than evidence is the basis for decision making.
31. Another example is the possibility, inferred by Vector, that the Commission might see the 67<sup>th</sup> percentile as an intuitive or somehow pragmatic step towards mid-point in the future. Vector said<sup>5</sup>:

"This risk has been heightened by comments of the Commission's Deputy Chair at the WACC draft decision analyst briefing on 22 July 2014, where it was indicated that the WACC may be "walked down" over time in future reviews of the percentile. Vector is particularly concerned that such comments imply a degree of pre-determination of future outcomes on the part of the Commission and would not adhere to any sound regulatory principles."
32. MEUG was present at the analyst briefing. Rather than a sense of re-determination by the Commission as Vector report; our sense was that the Commission could not find any reason now not to go to the mid-point but the 67<sup>th</sup> percentile was a pragmatic step in that direction cloaked in words about their "judgement" that really meant intuition or guess. Whatever the comment by the Commission at the analysts briefing meant it matters little given the Commission how has submission and cross-submission evidence it must use and arguments backed only by intuition by submitters it should dismiss.
33. We look forward to the Commission's final decision by 31<sup>st</sup> October 2014.

Yours sincerely



Ralph Matthes  
Executive Director

---

<sup>4</sup> Vogelsang, paragraph 2, 31<sup>st</sup> July 2014

<sup>5</sup> Vector, paragraph 98, p32, 29<sup>th</sup> August 2014

**Appendix 1****Other large electricity users' and representatives that support MEUG submissions and this cross-submission**

- ~ Employers and Manufacturers Association (EMA) Northern Inc.
- ~ Foodstuffs
- ~ Methanex
- ~ Nelson Pine
- ~ O-I Glass

A list of MEUG members follows with ordinary (ie companies) first and the last two being industry group members:

- ~ Carter Holt Harvey
- ~ Dongwha
- ~ Fletcher Building
- ~ Fonterra Cooperative
- ~ Heinz-Wattie's Australasia
- ~ Holcim
- ~ Lion
- ~ New Zealand Steel
- ~ Norske Skog Tasman
- ~ Oceana Gold
- ~ Pacific Aluminium
- ~ Pan Pac Forest Products
- ~ Progressive Enterprises
- ~ Ravensdown Fertiliser
- ~ Refining NZ
- ~ Whakatane Mill
- ~ Winstone Pulp International
- ~ Business NZ
- ~ Wood Processors and Manufacturers Association