



MAJOR ELECTRICITY USERS' GROUP

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Manager, IM Review
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Keston

Comments on Professor Yarrow's report on WACC for airports Information Disclosure

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission paper "IM Review – Professor Yarrow report and emerging views on the airport WACC percentile" published 19th February 2016 ("the CC emerging views paper").¹
2. Professor Yarrow's report was also published 19th February 2016.²
3. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
4. Professor Yarrow's report paints a broad picture of how regulators worldwide manage "the risk, or the eventuation of that risk, of adverse effects arising from the exercise of market power (AEEMP)".³ In markets where AEEMP is low regulatory tools other than WACC are important. At the other extreme natural monopolies have the highest risk of AEEMP and WACC is a critical part of the regulatory toolbox. Professor Yarrow's report then considers in detail the application of WACC for the airports information disclosure (ID) regime.
5. The CC emerging views paper asks specific questions in relation to the WACC for the airports ID regime. MEUG has not addressed those questions. Rather this submission highlights some insights in Professor Yarrow's report relevant to the review of Input Methodologies (IM) affecting regulated energy services.
6. The following themes highlighted by Professor Yarrow are important across all of Part 4 where WACC is used:
 - a) The principle of proportionality⁴.

¹ Document URL <http://www.comcom.govt.nz/dmsdocument/14089> at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/cost-of-capital-im-review/>.

² Professor Yarrow "Responses to questions raised by the Commerce Commission concerning WACC estimates for information disclosure purposes in the airports sector", dated February 2016. Document URL <http://www.comcom.govt.nz/dmsdocument/14090> at same web site in footnote above.

³ Ibid, p2, paragraph 1.

⁴ Ibid, p1

- b) Context is important and can change over time⁵. Incentives matter but are not straightforward to map. The following quote is an example of this theme:
- “In sum, the implications of any WACC estimate can only be assessed holistically, taking account of information conditions and incentive structures in their entirety.”⁶
- c) Direct tangible engagement between regulated suppliers and consumers should improve outcomes. There are two parts to engagement. First uncovering and meeting consumer preferences is critical though difficult to achieve.⁷ Second the accountability of the regulated supplier to explain differences between actual returns and WACC:
- “Since it is the airport, not the regulator, which determines prices, I think that it is reasonable to expect that the burden of such articulation falls first on the airport operator, particularly in ex ante exercises”.⁸
- d) “Systematic risk is itself a function of the regulatory approach adopted”.⁹
7. Professor Yarrow’s report discusses dual till effects for airports but argues these are less significant for gas and electricity networks on the basis that:
- “... the end user expects relevant services to be continuously available at a particular location and is indifferent to the particular routes by which electric power, gas molecules and electronic signals reach the relevant location.”¹⁰
8. MEUG suggests the question of whether dual till effects apply to EDB is not so easily dismissed nor potential risks dual till effects are manageable through the existing regime, primarily the Cost Allocation IM. Even if it is proven there are no instances of an EDB having complementary businesses that exhibit dual till effects the question then becomes will that situation arise in the future? MEUG suggests there is a high probability such a situation will occur. Emerging technologies such as batteries and solar PV do change how the electrons are delivered and customers are not indifferent to these alternatives. To retain regulatory certainty the Commerce Commission should be signalling now what thresholds would trigger a change to accommodate dual till effects and how the regime might change.
9. To illustrate MEUG’s contention dual till effects are or will be possible consider the three reasons in the CC emerging views paper supporting the current approach of using the mid-point WACC for airports and 67th percentile for regulated electricity and gas line services:
- “... we consider that the potential asymmetric impacts on consumers from underinvestment are likely to be weaker for airports compared to electricity and gas businesses because they:
- 16.1 are only subject to information disclosure (which means that the regulated WACC is only likely to have an indirect effect on investment decisions);
 - 16.2 are subject to dual-till structure (whereby they can earn significant amounts of revenue from unregulated complimentary activities); and
 - 16.3 have regular consultations with a small number of engaged customers (airlines).”¹¹

⁵ Ibid p4, paragraph 4.

⁶ Ibid, p9, paragraph 5.

⁷ Ibid, p7.

⁸ Ibid, p1, paragraph 4.

⁹ Ibid, p15, paragraph 6.

¹⁰ Ibid p14 paragraph 3.

¹¹ CC emerging views paper, paragraph 16.

10. The Commerce Commission assumes in paragraph 16.1 that companies subject to DPP and IPP care more about regulated WACC in making investment decisions than companies subject to ID. No evidence is provided by the Commission to support that view. Professor Yarrow's report explains that companies subject to ID do indeed care about regulated WACC not just in the current or immediate next regulatory period but over multiple future periods¹². Exactly the same questions will be exercising the minds of Boards of Directors of EDB subject to DPP.
11. The Commerce Commission assumes in paragraph 16.2 there are or will be no significant amounts of revenue from unregulated complementary activities for EDB. MEUG disagrees. Evidence of this trend are:
- a) At the Downstream conference last week Vector noted that average network sales volumes for households that have installed solar (8,185 kWh per annum) are higher than the average for an all-electric household (6,960 kWh per annum). Solar customers on average use 17.5% more electricity. Rather than emerging technologies being solely a threat to an EDB it may be that maintaining existing and building new distribution services to end consumers is an opportunity to leverage into unregulated businesses that could have significant value.
 - b) In Energy News last Wednesday it was reported Powerco had opened a new EV charging facility at its Bayfair centre in Tauranga. The article stated:
 "Michael Cummings, a Powerco director and head of AMP Capital's infrastructure equity funds in Australia and New Zealand, says the investment at Bayfair is an example of the firm's strength in real assets.
 "We've been able to leverage our property and infrastructure equity capabilities to create a solution that has far-reaching benefits for the local community, our business and investors."
 This illustrates that emerging technologies are quickly opening up opportunities for new business models including emulating dual till structures.
12. The Commerce Commission assumes in paragraph 16.3 that there are not and will not be a trend for regular consultations with a small number of engaged customers by EDB. MEUG disagrees. There is already a relatively high concentration of EDB customers in terms of a few large retailers on every EDB network and in some cases one or two very large time-of-use customers. The problem is those parties are not engaged with EDB because such engagement is one sided on key matters such as distribution agreement terms and conditions including pricing and quality trade-offs.
13. The barriers to effective engagement are likely to decrease due to a combination of both regulators, the Commerce Commission and Electricity Authority, being conscious of and wishing to facilitate more direct engagement (this aligns with the theme from Professor Yarrow noted in paragraph 6 c) above) and customers of EDB being prepared to take up any genuine ability for pro-active engagement. The establishment of the Electricity Retailers Association of NZ (ERANZ) for example will assist retailers to be more engaged as primary customers of EDB services. Another example is Transpower's consultation on a draft Transpower Works Agreement to replace various be-spoke contracts for investments and minor works. MEUG members and MEUG have actively engaged with Transpower on the terms and conditions of that proposed new umbrella contract proposal.¹³

¹² Professor Yarrow's report, p9, paragraph 6.

¹³ Refer MEUG to Transpower, Comments on draft Transpower Works Agreement, 26th February 2016, document URL http://www.meug.co.nz/system/files_force/MEUG%20to%20Transpower%2C%20Transpower%20Works%20Agreement%2C%2026-Feb-16.pdf?download=1 at <http://www.meug.co.nz/>

14. Finally the notion that airports compete at nodes of a transport system whereas in electricity one company owns all of the nodes on the system is suggested in Professor Yarrow's report as another characteristic of why dual till applies to airports but not electricity networks.¹⁴ MEUG suggest that proposition needs further testing because with EDB there are competing networks some of which have nodes connected to the grid. Those competing networks provide a platform for selling complementary services such as batteries and PV. Would an EDB compete to build a network to connect customers it could sell complementary services too? If so then that looks like a dual till structure.

Yours sincerely



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¹⁴ Professor Yarrows report, p13.