



# MAJOR ELECTRICITY USERS' GROUP

4<sup>th</sup> August 2016

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Manager, IM Review  
Commerce Commission  
By email to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

Dear Keston

## **Submission on Input methodologies draft review decisions**

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission's suite of draft decision consultation papers related to the Input Methodologies (IM) review published 16<sup>th</sup> June 2016, text of proposed changes to IM determinations published 22<sup>nd</sup> June 2016 and related materials.<sup>1</sup>
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. Attached and to be read as part of this submission are:
  - a) Report by Mike Hensen of the New Zealand Institute of Economic Research (NZIER), Form of Control for EDB – draft decision, Advice on submission to the Commerce Commission, 3<sup>rd</sup> August 2016; and
  - b) Report by Garth Ireland of Ireland, Wallace & Associates Limited (IWA), "Input methodologies review draft decisions" – Risk Allocation between Suppliers and Customers, 4<sup>th</sup> August 2016.
4. This submission has ten sections:
  - a) The first section comments on the future evolution of the regulatory regime and IM.
  - b) Submissions on Topic papers 1 to 7.
  - c) Comments on the draft decision as whole are in the ninth section.
  - d) The last section has concluding comments.

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<sup>1</sup> Refer <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>

## Future evolution of the regulatory regime and IM

5. MEUG believes the purpose of the IM has largely been achieved meeting Parliaments legislative requirement when Part 4 was enacted in 2008 “to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods and services under the Part.”<sup>2</sup> This has been achieved with the inaugural IM determined in 2010 along with case law established in the subsequent merit review. There is now more certainty on processes for changing and calculus of key building blocks for regulating monopoly services consistent with the statutory purpose for the IM compared to the uncertainty before 2008. The calculus of the building blocks is largely known except in respect to cost of capital uncertainties (discussed in paragraphs 30 to 37). New uncertainties now face electricity sector participants. Part 4 and the IM need to be viewed in light of those uncertainties.
6. The Commission at the outset of the IM review early last year was aware of the possibility of emerging technologies and new business models disrupting regulated service businesses and the response of consumers using those services. In general sector participants were alive to those future risks (and opportunities) then and continue to be so. MEUG also considers it's a matter of when not if disruptive events will reshape the electricity sector globally and that also creates opportunities as well as risk for New Zealand.
7. The Commission does not consider IM need to change materially in anticipation of disruption to the electricity sector - see for example the draft decision, “Based on the information available to us, we do not currently consider that major changes to the IMs are needed at this time”.<sup>3</sup> There is one exception to cater for such disruption noted in the next paragraph. Overall though the Commission draft decision is that changes to IM to manage those risks and new uncertainties can be delayed to a future review.
8. The exception is a proposal for EDB to accelerate depreciation described in the draft decision as “However, as a precautionary measure, we propose to allow EDBs to recover the costs of assets more quickly.”<sup>4</sup> The specific pros and cons of that proposal are discussed later in paragraphs 17 to 19.
9. The draft decision states “For the avoidance of doubt, while our IM review was not aimed at answering the question, we have not found evidence to suggest that electricity lines services no longer have natural monopoly characteristics, now or probably in the medium term.”<sup>5</sup> This begs the question what about the long-term? Promoting the long-term benefit of consumers is the purpose of Part 4 regulation. Both consumers and suppliers need certainty on the long term and that near term and medium term regulatory arrangements are consistent with likely long term constructs.
10. If no external change were to happen or likely to happen to the electricity sector then the opening comments in paragraph 5 above that the IM have largely achieved what Parliament intended in 2008 and would justify incremental improvements to the current IM. However faced with long-term disruptions the evolution of IM and Part 4 in the long term needs to be considered to ensure near term changes to IM can accommodate and not obstruct long-term change in the structure of the market. MEUG suggest it is necessary to consider the evolution of the IM in broader terms in anticipation of the certainty of disruption in the electricity sector in terms of how that disruption may change industry structures and supplier and consumer behaviours. In that broad context we don't think the current review

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<sup>2</sup> Commerce Act, Part 4, s.52R.

<sup>3</sup> Topic paper 3: The future impact of emerging technologies in the energy sector, paragraph X6, p5.

<sup>4</sup> Ibid, paragraph X9, p5.

<sup>5</sup> Ibid, paragraph 48.2.3, p25.

has advanced understanding of or adaption to the long-term direction of travel and increases the risk that future IM changes will need to be reactive.

The approach to have incremental changes to the IM now may be prudent given there are reasons why a refresh of Part 4 and the regulatory framework should be considered within the next 4 to 5 years. Those reasons include:

- a) MBIE is currently consulting on changing the current regulation of fixed line communication services to a "utility style" framework.<sup>6</sup> In essence to a Part 4 regulatory regime after 2020. At that date Part 4 will be 12 years old and a re-fresh to consider its application to telecommunications and lessons learned to date from existing Part 4 regulated entities would be prudent.
- b) MBIE has made an assessment of the merit review provisions in Part 4 given the experience of all parties with the 2010 IM decisions merit review proceedings. There may be legislative changes that emerge from that assessment.
- c) Aspects of Part 4 and the current IM to be considered in a post 2020 refresh include:
  - i) How Part 4 can be modified to give investors in businesses providing regulated services and their customers certainty on how a process to exit regulation can be managed and the factors to be considered.
  - ii) As part of considering how we can migrate services from being controlled to not being controlled whether the existing arbitrate-negotiate provisions of Part 4 that have never been exercised could play a role as a transitional regulatory approach.<sup>7</sup>
  - iii) A cohesive and consistent view of how different regulated services with different levels of demand elasticity are regulated. This links with the above point about certainty on the process and factors that would lead to less regulation (or more regulation) and exit from (or entry into) certain types of Part 4 regulation.

Another theme of ensuring a cohesive and consistent view across all regulated sectors is consistency in allocation of risk using a table listing risks in a standardised format along with a narrative explaining why risks may be assigned to different parties in different sectors. This is discussed in the IWA report and noted as an IWA recommendation in paragraph 43 a) later in this submission.<sup>8</sup>

Implementing a cohesive and consistent view of the current regulatory approach across and within sectors will assist consumers and suppliers anticipate how current settings for a specific regulated service might change given precedents observed in other sectors. That pro-active approach of signalling the direction of travel using a framework reconciling current practice is lacking in the draft decision.

- iv) How to manage economic stranding in a comprehensive manner that gives certainty for all parties as a change in the market starts to erode the monopoly characteristics of a hitherto regulated service. The current IM review did not

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<sup>6</sup> <http://www.mbie.govt.nz/info-services/sectors-industries/technology-communications/communications/regulating-the-telecommunications-sector/review-of-the-telecommunications-act-2001/telco-review-options-paper>

<sup>7</sup> Topic paper 3: The future impact of emerging technologies in the energy sector, footnote 43, p25, notes the Australian National Competition Council consideration of information disclosure and negotiate arbitrate arrangements in relation to Queensland gas distribution networks and "the precarious competitive position of gas" given end users have choice to substitute to other forms of energy.

<sup>8</sup> One approach to improving certainty to consumers and suppliers on the risk allocation across sectors and within sectors any differences along the supply chain would be to have a new risk allocation input methodology.

consider this matter in any detail because it was viewed as something a subsequent IM review up to seven years hence could reassess apart from the proposed option for EDB to use accelerated depreciation. That proposal does not appear to be part of a comprehensive plan over time to manage a wave of change.

- v) Related to the above is the Electricity Authority's latest proposed Transmission Pricing Methodology (TPM) guidelines to include a requirement for publication by Transpower of the value of any future new investment optimised downward to reflect the difference between charges for that investment at its construction cost exceeding the benefits of the investment to consumers. The current IM do not provide for such an economic stranding value to be reflected in an adjustment in RAB. Making transparent a poor decision by Transpower (as proposed in the revised TPM guidelines) improves, but is not equivalent to, the incentives on a company in a workably competitive market to avoid making poor decisions. In workably competitive markets shareholder's bear the risk of economic stranding and arguably Transpower's shareholder should also. A refresh of the IM and Part 4 should consider a reconciliation of the draft TPM guidelines and RAB IM. IWA 's report notes "It is very important that the Commission communicates in detail on how it identifies and allocates risks to suppliers and customers for each price setting period. This will enhance certainty for interested parties."<sup>9</sup>
- vi) Also related to the above is the Electricity Authority's concern in both the TPM guidelines and its letters to the Commission on the input methodology review about ensuring efficient pricing of the access to transmission and distribution assets in response to both the form of control and emerging technologies decisions.

### **Topic 1: Form of control and RAB indexation**

- 11. This section discusses:
  - a) The form of control for EDB; and
  - b) Indexing Transpower's RAB to inflation; and

#### **The form of control for EDB draft decision**

- 12. MEUG asked NZIER for their view on form of control for EDB. NZIER's report is attached. NZIER conclude "The decision to move to a revenue cap seems to enable continuation of the current mixed practice for volume billing among EDB without clear evidence of a correlation between the variation in revenue and EDB capital expenditure. The potential for quantity forecasting risk to be lowered by EDB aligning their basis for charging with the cost of providing access to the electricity network does not appear to have been evaluated as an alternative to the introduction of a revenue cap."<sup>10</sup>
- 13. Consequently MEUG's view remains unchanged from that submitted in March this year based on NZIER's advice at that time and we do not believe changing from Weighted Average Price Control for EDB to revenue cap is in the best long term interest of consumers.<sup>11</sup>

<sup>9</sup> IWA report attached to this submission, paragraph 2.7.

<sup>10</sup> NZIER report attached to this submission, section 2.4, p6.

<sup>11</sup> MEUG and NZIER submissions on emerging views on form of control, 24<sup>th</sup> and 21<sup>st</sup> March 2016.

### **Indexing Transpower's RAB to inflation<sup>12</sup>**

14. MEUG agrees with the Commerce Commission's draft decision to retain the approach of not indexing Transpower's RAB to inflation. Our view might change depending on any future revision to the TPM. If in the future a re-alignment of a changed TPM and RAB IM is required (see discussion paragraph 10 v) above) it would likely make the proposed annual capital charge adjustment through the Maximum Allowable Revenue (MAR) wash-up obsolete. Given there will be a cost of implementing the proposal and no assessment in the draft decision of possible benefits (other than an open question for views on what those might be) plus uncertainty on if and how future integration of the RAB IM and TPM might evolve, MEUG has no basis to know if the proposal is beneficial or not.

### **Topic 2: CPP requirements**

15. MEUG agrees with the policy intent for changes to consumer consultation requirements for CPP applicants.<sup>13</sup> Changes to improve implementation of the draft decision follow:

- a) A separate verifier with expertise in public consultation should be engaged.

We would not expect a specialist in public consultation processes to be the person consumers would have confidence in to provide an informed expert view on EDB cost proposals. Similarly an engineer cannot be considered an expert in public consultation.

A change is therefore proposed to Schedule F, Engagement of a Verifier, to allow for two separate verifiers. One for the proposed new role, purpose and obligations in the Draft IM Electricity Distribution Services (EDS) IM, Schedule G, cl. G2 (1) (g) "... providing an opinion on the extent and effectiveness of the CPP applicant's consultation with its consumers."<sup>14</sup> The other verifier for all of the other roles, purposes and obligations in schedule G.

- b) More prescription is needed in specifying consumer consultation requirements.

The proposed new requirement in the list of information that a CPP applicant must notify its customers is welcome, ie to adequately notify its customers "of the price versus quality trade-offs made in the expenditure alternatives considered in the intended CPP proposal."<sup>15</sup>

There are multiple risks in delivering the intent of this policy. In sub-paragraph a) above we consider a solution to the fact that verifiers of engineering matters may not be qualified to verify consultation processes.

Another risk is a CPP applicant providing insufficient information at one end of the spectrum and at the other detailed information that is impenetrable and incomprehensible to anybody other than industry experts. There is also a risk of misinformation be it unintentional or intentional. The latter should be mitigated by suitably skilled verifiers working as a team.

<sup>12</sup> Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower, Chapter 6, pp54-55.

<sup>13</sup> Topic paper 2: CPP requirements, Chapter 8, pp81-85.

<sup>14</sup> Draft Electricity Distribution Services IM, Schedule G, cl. G2(1)(g), 22<sup>nd</sup> June 2016

<sup>15</sup> Ibid, proposed new cl. 5.5.1(1) (c).

An example of the difficulties in having appropriate communication of line charge information occurred in prior years when tariffs were reset each year. This led to the EA in April 2015 introducing "guidelines for distributors and retailers on their communications to consumers and the media concerning price changes in order to improve the transparency of consumers' electricity charges".<sup>16</sup> The EA is monitoring uptake of the guidelines and if needed will regulate. If a problem emerges the EA has the option of intervening to ensure the problem is not repeated in future years.

With CPP applications the form and quality of informing consumers of the price versus quality trade-offs is at the discretion of the CPP applicant. Unwittingly or wittingly the communication of this trade-off in a form consumers can understand (and respond to in an informed manner) may miss the mark. There is a risk that a CPP application complete in all aspects apart from adequate information to consumers on price-quality trade-off may be allowed to proceed because tidying up the communication with consumers is deemed important but dispensable to get the CPP completed. The experience of the difficulty of getting good communication to consumers discussed in the paragraph above is a warning that this scenario of a good CPP application other than the consumer consultation requirement is feasible. The example in the prior paragraph had a good regulatory back-stop whereby the EA could intervene should compliance with the guidelines falter. There is no similar incentive on EDB applying for a CPP to ensure their consumer consultation is adequate because the Commission could not regulate a format and details of consumer consultation once an application was lodged and the CPP applicant may never ask for another CPP in the future.

An option to consider is whether it's better to head off the risk of consumers receiving poor information on trade-offs by either prescribing a specific tabular format or process the CPP applicant must comply with. For example:

- A tabular format could require disclosure for each tariff category, for each year ending 31<sup>st</sup> March that the CPP is intended to apply, the CPP applicants forecast of the average, minimum, maximum, 67<sup>th</sup> and 33<sup>rd</sup> percentile prices (see next sentence for definition of price in this context), total tariff class revenues and forecast quality metrics for the proposed CPP, the current DPP and other options considered but not proposed. "Price" in this proposed table means each of the components of a line tariff billed to an end consumer or a retailer and the sum of those components expressed on a c/kWh average equivalent and \$/MW connection capacity average equivalent.
- Alternatively the IM could prescribe a process where a CPP applicant must consult with end consumers or agents for end consumers (retailers or parties such as MEUG and the Electricity Retailers Association of NZ (ERANZ)) to agree the tabular format to satisfy the new requirement to ensure consumers make informed feedback to the CPP applicant. To ensure adequate consultation end consumer and representatives to be consulted could be defined as representing at least a third of total annual consumption provided that there are at least 5 different such consumer or representative parties to avoid the case where there is high retailer and or industrial end-consumer concentration.

There is a cost to both of the above options. MEUG suggests it is worth considering if the additional cost is worth paying if it uncovers consumers' true preferences.

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<sup>16</sup> EA web page <http://www.ea.govt.nz/operations/distribution/distributors/>.

### Topic 3: The future impact of emerging technologies

16. This section discusses:
- a) The option to shorten asset lives;
  - b) Tightening cost allocation IM; and
  - c) Explicit innovation incentives.

#### **The option to shorten asset lives<sup>17</sup>**

17. The draft decision frames the policy question of risk of partial capital recovery due to the potential for consumers to bypass distributors networks either directly or indirectly through new non-regulated service providers leading to “an EDB’s network may be used by fewer consumers and the EDB may not be able to fully recover the costs of its historic investment from its remaining consumers.”<sup>18</sup> This is economic stranding of the network because the network is still being used, even if very lightly, but the NPV=0 principle for an EDB is not met because consumers will not pay line tariffs to achieve NPV=0. The problem being considered in this section is not asset stranding where an asset isn’t used at all but where the undepreciated value is still recovered in the RAB.<sup>19</sup>
18. The draft decision then explains that in the view of the Commission “the available evidence is inconclusive on whether the risk of partial capital recovery for EDBs regulated businesses has increased, and by how much.”<sup>20</sup> The evidence to support this conclusion is in Topic paper 3 appendix A of the draft decision. Three of the four pieces of evidence in that appendix are related primarily to energy volumes and have little to do with local coincident peak demand that drives local EDB investment.<sup>21</sup> The fourth piece of evidence in that appendix in slide 16 refers to the fact that forecast EDB capital expenditure has not decreased. There is no analysis whether that greater predicted expenditure will reduce operating costs and thereby lower tariffs or is needed to improve quality demanded or in some parts of the country (but not all) predicted population growth. MEUG believes the Commerce Commission have a very thin argument if they are relying on aggregate forecast increase in capital expenditure as the only reason to be inconclusive on the risk of partial capital recovery.
19. The draft decision then discusses two alternative solutions to the problem. First the preferred solution of EDB applying for a shortened asset life when DPP are reset with a 15% cap on average shortened lives. Second ceasing RAB indexation.

The draft decision notes that both options will increase line charges. For the proposed option of shortened asset lines the Commission note “Based on the 2015-2020 DPP model, and all other things equal, we estimate that a 15% reduction in remaining average asset lives would have resulted in an approximately 3-6% increase in starting prices (ie, average distribution charges).”<sup>22</sup> For the ceasing RAB indexation option “approximately a 7-10%

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<sup>17</sup> Topic paper 3: The future impact of emerging technologies in the energy sector, Chapter 3, pp 31-37

<sup>18</sup> Ibid, paragraphs 73 and 74.

<sup>19</sup> Ibid, paragraph 75.

<sup>20</sup> Ibid, paragraph 81.

<sup>21</sup> Ibid, slides 16-20, p61-63. The three pieces of evidence that MEUG submits are not directly relevant to taking a view on the future economic stranding risk for EDB and Transpower are forecast electricity demand, forecast electricity prices and generator share prices. The latter includes Vector share prices. As Vector is a diversified business with unregulated revenues in excess of 50% of total revenues (refer Topic paper 3, table B1, p66) it is not a reliable indicator of an average EDB.

<sup>22</sup> Ibid, paragraph 91, p35.

increase in line charges depending on the EDB".<sup>23, 24</sup> MEUG do not consider either proposal is for the long term benefit of consumers as follows:

- a) Referring to the line tariff increases faced by consumers with the option to cease RAB indexation, the draft decision notes "This would risk worsening the problem".<sup>25</sup> That is if consumers were electing to invest or change their consumption to directly or indirectly bypass use of the network and one of the factors driving that were the level of line tariffs, then giving consumers even higher line tariffs would incentivise more consumers to bypass the network.

The same argument applies to the smaller yet still material increase in line charges for the accelerated depreciation proposal. The draft decision paper discussion does not weigh that dis-benefit for the preferred option.

- b) The draft decision analysis only considers keeping EDB whole. There is no consideration of inefficient investment, divestment or change in consumption behaviour by consumers accelerated by higher prices with both options. And importantly the expectations by consumers of the future direction of regulatory change as lower cost emerging technologies are more widely adopted and new services offered. Consumers will see the adoption of a capped accelerated depreciation option exercisable by individual EDB as the likely direction of future change. The once only exercisable option and cap will not be viewed by a sceptical public as sacrosanct. The economics of a consumer choosing to reduce their use or exit the network earlier rather than wait to see what other consumers do will be more attractive. In that case there will be over-investment (or earlier than optimal) in capital and operating practices to avoid networks and NZ Inc. will be worse off.
- c) For MEUG the question to ask is what would happen in workably competitive markets in a similar situation? Faced with an emerging technology we don't think a business would raise prices. On that basis alone the proposal to allow accelerated depreciation is not well based and therefore not supportable.

#### **Tightening cost allocation IM<sup>26</sup>**

20. MEUG supports tightening the thresholds as a minimum and we will be interested in the views of retailers that are more incentivised and therefore informed on the tension at the boundary between regulated services and workably competitive markets. MEUG is likely to consider this topic in the cross-submission phase.
21. Disappointingly the draft decision never considered the earlier MEUG submissions that one or part of a solution could be to review "the Commerce Commission decision in 2012 not to require regulated suppliers to disclose regulatory consolidation statements."<sup>27</sup> Though this is a change in the Information Disclosure requirements we still believe it and changes to the Cost Allocation IM is a feasible packaged solution that should have been considered.

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<sup>23</sup> Ibid, paragraph 97, p36.

<sup>24</sup> Note MEUG is not entirely sure if the ceasing RAB indexation would increase prices as estimated by the Commerce Commission. For the purpose of this submission we have assumed the analysis as presented but may re-consider in the cross-submission phase.

<sup>25</sup> Ibid, paragraph 97.

<sup>26</sup> Ibid, Chapter 4, pp38-59, Attachment B, pp64-65 and EA letter to Commerce Commission, Implications of regulatory treatment of cash flows for emerging technology, 1<sup>st</sup> June 2016.

<sup>27</sup> MEUG to Commerce Commission, Submission on Emerging technology pre-workshop paper: 30 November 2015, paragraph 7 b), 4<sup>th</sup> February 2016.

**Explicit innovation incentives<sup>28</sup>**

22. Orion, PwC (on behalf of 19 EDB) and Transpower, amongst others, “suggested that the IMs should include specific incentives for EDBs to invest in research and development in relation to emerging technologies.”<sup>29</sup> The Commerce Commission “is not convinced” with these arguments.<sup>30</sup> MEUG agrees with the logic in the draft decision declining to insert additional explicit innovation incentives into the IM.
23. There is one clarification to the draft decision as follows.<sup>31</sup> Paragraph 65 in Topic 3 of the draft decision explains why the Commerce Commission consider the current regime, the IM being part of, place adequate incentives on EDBs to innovate. Missing from that narrative is the option exercisable only by businesses with regulated services subject to DPP to apply for a CPP to “better meet their particular circumstances.”<sup>32</sup> The latter reference to particular circumstance presumably could include innovation investment issues peculiar to a specific EDB.

**Topic 4: Cost of capital issues**

24. This section discusses:
- a) Debt issuance costs should be 0.1% not 0.2%.
  - b) Use of a Term spread credit differential (TSCD)
  - c) Material uncertainties requiring further research:
    - i) The Simplified Brennan Lally Capital Asset pricing Model (SBL-CAPM) leverage anomaly;
    - ii) Black’s Simple Discount Rule (BSCDR) as a cross-check; and
    - iii) Use of the 67<sup>th</sup> percentile WACC for asymmetric risk.

**Debt issuance costs<sup>33</sup>**

25. MEUG agrees, with two exception, with the draft decision statement that “In general, we do not consider that there are significant issues with our current methodology for estimating the cost of debt. Although a number of submissions focused on cost of debt issues, the changes that we propose are generally minor. They are intended to be relatively small incremental improvements to our current methodology”.<sup>34</sup> The two exceptions are the draft decision on debt issuance costs discussed in this section and use of a TSCD discussed in the next section.
26. Referring to issuance costs the draft decision states “Information received from the 2016 debt survey and submissions suggest that these costs are more likely to be in the region of 5-10 bps p.a. for debt issued with a five-year original maturity term. Swap costs appear to be in the region of 2 bps per swap.”<sup>35</sup> MEUG believe that on the basis of those market survey derived values issuance costs should be approximately 10 bps.

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<sup>28</sup> Ibid, paragraphs 62 to 69, pp28-30.

<sup>29</sup> Ibid, paragraph 62 and footnote 49.

<sup>30</sup> Ibid, paragraph 66.

<sup>31</sup> This clarification is of the Commerce Commission’s view on the current balance of the IM. This does not imply MEUG agrees with the balance of risk allocation or the values used for all building blocks.

<sup>32</sup> The phrase “better meet their particular circumstances” is used to describe the purpose of CPP compared to DPP in the Commerce Act, Part 4, s.53 K, Purpose of default/customised price-quality regulation.

<sup>33</sup> Topic paper 4: Cost of capital issues, paragraph 218 to 246

<sup>34</sup> Ibid, paragraph 84.

<sup>35</sup> Ibid 244.

27. Surprisingly the draft decision goes on to state “Given the uncertainty of these costs we do not consider we should be too precise in trying to replicate costs using a bottom-up approach. Instead we consider, on the basis of the available evidence, that the allowance for debt issuance costs should be no higher than 20 pbs p.a. for debt with a five-year term. We consider this is sufficient to cover the costs of issuing NZ domestic corporate bonds (5-10 bps) and costs of any required swaps (~4 bps). Given the uncertainty and variability of the various costs, we consider it is prudent to include an additional margin to cover other issues related to debt issuance.”<sup>36</sup> MEUG finds this draft decision surprising because:
- a) No explanation is given of “other issues related to debt issuance” mentioned at the end of the prior quote and the scale of those costs to justify an additional margin.
  - b) No detailed evidence is tabled of the range of the variability of cost components of debt issuance to support shifting from the mid-point of market surveyed costs of approximately 10 bps to 20 bps. In any case even if a probability distribution of those cost components were available that should then be factored into the 67<sup>th</sup> percentile mark-up above the midpoint for the WACC as a whole for asymmetric risk and the market survey based mid-point estimate of debt issuance costs used.
28. MEUG therefore recommends debt issuance costs be set at 10 bps and the standard error of that mid-point estimate be included in calculating the overall WACC adjustment for asymmetric risk by way of the 67<sup>th</sup> percentile. By adopting that approach, consistent with the way all other parameters of WACC are treated, it’s likely the standard error for debt issuance will be considered immaterial – whereas having 10 bps plus mark-up as proposed in the draft decision is material (as well as being inconsistent with treatment of errors in estimating WACC components).

#### **Term Spread Credit Differential<sup>37</sup>**

29. MEUG agrees with the view of the High Court that the TSCD should be removed and the subsequent arguments in this review process submitted to date by Contact Energy.<sup>38</sup>

#### **SBL-CAPM leverage anomaly<sup>39</sup>**

30. MEUG agrees with the draft decision that the Commerce Commission “do not propose to change the choice of model used to estimate the cost of equity when determining the WACC.” Our agreement to retain the status quo does not mean we have to change our long standing view that the SBL-CAPM has material flaws. Those flaws should not be waived away or forgotten, and the Commerce Commission should continue to work on possible solutions given the materiality of the flaws.
31. The Commerce Commission concedes that SBL-CAPM biases WACC in favour of suppliers of regulated services. For example draft decision states “On the whole we consider there is a greater chance that the SBL-CAPM overstates the WACC than underestimates the WACC”<sup>40</sup> and “... there is some evidence to suggest that the WACC may be generous to suppliers ...”<sup>41</sup>

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<sup>36</sup> Ibid, paragraphs 245 and 246.

<sup>37</sup> Ibid, paragraphs 193 to 201

<sup>38</sup> Ibid, paragraph 194 quotes the High Court and paragraph 195 the view of Contact Energy.

<sup>39</sup> Ibid, paragraphs 520 to 533.

<sup>40</sup> Ibid paragraph 529.

<sup>41</sup> Ibid paragraph 531.

32. The potential scale of this bias in favour of suppliers is not discussed in the draft decision. MEUG last mentioned the possible scale in submissions March last year based on evidence tabled at the merit review of between \$62m and \$132m per annum.<sup>42</sup> Later in paragraph 37 we suggest the Commerce Commission should commence research towards finding solutions to this anomaly.

#### **Black's Simple Discount Rule<sup>43</sup>**

33. The draft decision concludes "We do not propose to use the BSDR as a cross-check on the WACC until some of the identified issues have been resolved."<sup>44</sup> MEUG agrees. In our earlier submissions MEUG pointed out that there were aspects of BSDR that needed to be resolved before it could be considered as a tool for cross-checking CAPM derived cost of capital.<sup>45</sup>
34. In those earlier submissions MEUG proposed "Given that Dr Lally confirmed that BSDR is theoretically a useful cross check on using the Capital Asset Pricing Model (CAPM) to estimate WACC in the context of valuation and regulation, the Commerce Commission should develop a dialogue with Professor Loderer."<sup>46</sup> We thought that suggestion was pragmatic because "MEUG believe the cost of seeking further academic advice on implementation will be minimal compared to the insights BSDR may bring as a cross-check especially given the general concern about the model and parameter estimation issues."<sup>47</sup> The draft decision does not consider MEUG's suggestion of weighing the cost of seeking further expert advice with the probability weighted benefit if BSDR found to be a useful cross-check. We don't know the reason for not considering that option though it may simply have been insufficient time. We discuss the need to initiate such research as soon as possible in paragraph 37 below.

#### **Use of the 67<sup>th</sup> percentile WACC for asymmetric risk**

35. Having amended the WACC percentile last year understandably this was not a topic for this year's review. There is still uncertainty from consumers' viewpoint whether the approximately \$80m per annum paid being the uplift from the mid-point to the 67<sup>th</sup> percentile is reasonable for possible asymmetric risk.<sup>48</sup> For example:
- a) The draft decision states "Professor Vogelsang also observed that if suppliers are already at or past the optimal level of investment, there is no benefit to consumers in incentivising increased investment"<sup>49</sup>
  - b) There is no evidence the change from the 75<sup>th</sup> to 67<sup>th</sup> percentile destabilised investment plans by EDB or Transpower.
36. It remains an open question whether further decreases in the percentile are possible. Given the materiality of this asymmetric risk uplift we suggest the Commission should continue work on improving methods to estimate the optimal percentile.

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<sup>42</sup> MEUG to Commerce Commission, Comments on scope, timing and focus for the review of input methodologies, paragraph 9 b), 20<sup>th</sup> March 2015.

<sup>43</sup> Topic paper 4: Cost of capital issues, paragraphs 631 to 658.

<sup>44</sup> Ibid, paragraph 656.

<sup>45</sup> MEUG to Commerce Commission, Comments on advice by Dr Lally to the Commerce Commission on WACC issues, 24<sup>th</sup> March 2016.

<sup>46</sup> Ibid, paragraph 37 b).

<sup>47</sup> Ibid, paragraph 4 a).

<sup>48</sup> MEUG to Commerce Commission, Submission on Input Methodologies review – Invitation to contribute to problem definition, paragraph 25, 19<sup>th</sup> August 2015.

<sup>49</sup> Topic paper 4: Cost of capital issues, paragraph 146, p44.

37. Research on ways to better estimate the optimal percentile to manage asymmetric risk is not trivial and will likely require further academic research and may take time to complete. Similarly further consideration of the SBL-CAPM anomaly and BSDR will need academic research. The Commerce Commission could consider ways to engage with universities and finance and economics practitioners to develop work plans to investigate these outstanding issues in cost of capital as it applies to regulated services in New Zealand. In that way when the next IM review commences in five years' time to meet the seven years for completion of the next review no later than 2024, we will be better prepared than this review, the WACC percentile amendment last year and when the inaugural IM were set in 2010.

#### **Topic 5: Airports profitability assessment**

38. No comments.

#### **Topic 6: WACC percentile for airports**

39. MEUG has no comments on the draft decision and changes to IM on the WACC percentile for airports.
40. MEUG is interested in two aspects of the draft decision as possible precedents for other Part 4 regulated sectors:
- a) First the requirement for airports to provide a narrative on cost of capital and profitability may be a useful for EDB. Also this would complement the proposal for a template for the Commerce Commission to describe how risks are allocated as recommended by IWA (see paragraph 43 a) and b) below).
  - b) Second airports are the least regulated of all Part 4 regulated services. As discussed in paragraph 10 above in the section on future evolution of the regulatory regime and IM, MEUG believes it is important that there is cohesive and consistent view across different regulated services to ensure certainty on the path a service can exit from being regulated.

#### **Topic 7: Related party transactions**

41. The proposed approach to considering related party transactions is appropriate. We look forward to the Commerce Commission's update in early September on next steps.

#### **Comments on the draft decision as a whole**

42. MEUG asked IWA for their view on risk allocation of the draft decisions with respect to Transpower primarily and any insights for other regulated services.<sup>50</sup> IWA's report is attached.

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<sup>50</sup> The specific instructions are in IWA report, section 1, p4.

43. IWA recommend<sup>51</sup>:
- a) "As the Commission allocates risk through implementing the IM and in setting revenue caps it now could assist interested parties by describing the risk allocated to suppliers and customers in a summary table. It should also provide narrative on the reasons one or both parties are best placed to manage or share risk. This is key economic Principle 2."
  - b) "The Commission should support its asset beta number with narrative on what it considers the factors that explain it. The asset beta number and the risks that underlying it are a package. If regulated suppliers follow Transpower's methodology in its TWA in pricing of its services interested parties will be more aware of potential for risk shifting and of course the concept of risk-adjusted return. This is key economic principle 1"
  - c) "The Information Disclosure requirements should be changed to enable the Commission to detect risk shedding. At present risk shedding can't be detected as neither revenue nor the normal profit are affected."
44. The Commerce Commission in weighing submissions needs to adopt IWA recommendations a) and b) above to provide clarity and certainty to regulated suppliers and consumers of how the proposed revised IM allocate risk. This is necessary for the Commerce Commission to ensure it has meet its own economic Principle 2.
45. Both IWA recommendations a) and b) would also assist the research on material uncertainties on cost of capital (paragraph 37 above) as well as informing any re-refresh of Part 4 and IM as discussed in paragraph 10.
46. IWA recommendation c) with respect to Information Disclosure should be considered in the next review of the Information Disclosure requirements.

### Concluding comments

47. We look forward to reading and cross-submitting as needed on the submissions of other parties.
48. Last but not least we are appreciative of the clear communication of material and timelines in this review and the prompt response and accommodating approach of Commerce Commission staff to answer questions and attendance at meetings and conference calls with MEUG members and MEUG's advisors.

Yours sincerely



Ralph Matthes  
Executive Director

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<sup>51</sup> Ibid, section 4, p8.