COMMERCE COMMISSION NEW ZEALAND
Te Komihana Tauhokohoko

Risk allocation under price-quality regulation

Input methodologies review forum

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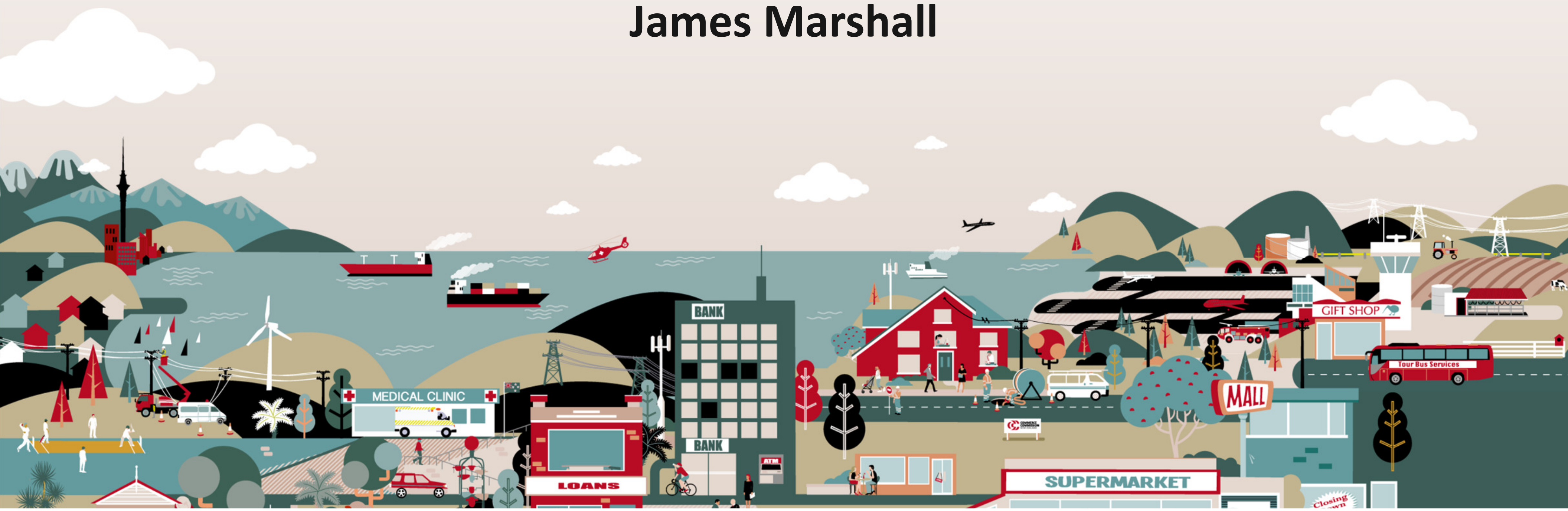

Purpose of this session

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- Consider risk allocation in a holistic way
- Identify views regarding:
  - existing risk allocation (ie, is there a problem?)
  - possible changes to regulatory mechanisms that affect risk allocation (ie, is there a more appropriate solution?)
- Specific issues raised include:
  - form of control
  - indexation of the RAB

Risk comes from uncertainty about outcomes

There are a number of sources of risk to suppliers and consumers of regulated services

Who should bear this risk?

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Guiding principles

- We seek to allocate risk to those best placed to manage them. This includes:
  - Control over probability of occurrence
  - Ability to mitigate costs of occurrence
  - Ability to absorb costs where they cannot be mitigated
- Important to provide incentives for suppliers to manage risks which they have control over because:

→ It leads to more efficient outcomes and is consistent with workably competitive markets

→ In the long-term interests of consumers

Managing risks under a price-quality path

Risk mitigation and compensation

- There are a number of risk mitigation mechanisms that reduce the volatility of price path returns to suppliers
- Investors generally expect compensation for ‘systematic’ risks, but ‘non-systematic’ risks are considered diversifiable
- Impact of asymmetric effects needs to be considered
- Focus on long-term benefit of consumers

“We seek to compensate suppliers either ex-ante and/or ex-post for the prudent and efficiently incurred material costs of managing risks, consistent with it expecting to earn normal returns, and where it is in the long-term benefit of consumers that we do so.”

Regulatory design has an impact on overall risk exposure

Design Issue	Current IM approach (Excl. Capex IM)
RAB recovery	Actual capex enters RAB from next period, no ex-post prudency assessment
RAB indexation	EDBs, GPBs (CPI-indexed RAB), Transpower (unindexed RAB)
Asset lives and depreciation	Physical asset lives as listed in IMs, straight line depreciation
Form of control	EDBs, GDBs (WAPC, indexed by CPI), Transpower (Revenue Cap), GTBs (Either, DPP uses revenue cap)
Reconsiderations	Available for catastrophic events, legislative/regulatory change, error, and fraud. Impact must be >1% of revenue.
Customised price-quality path (CPP)	Supplier has an option to apply for an amended price path taking into account a supplier's specific circumstances
Pass-through allowances	Listed pass-through and recoverable costs can be directly passed through to consumers
Risk management allowances	Ex-ante allowances for risk management costs in long-term interest of consumers (eg, insurance costs, TCSD)

Issues raised with current approach

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- Overall we believe the current IMs are broadly appropriate for allocating risk under a price-quality path to promote the long-term benefit of consumers

- Submissions on open letter suggested areas in which risk allocation could potentially be improved
  1. Form of control
  2. Indexation of the RAB

Form of Control

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Revenue cap vs price cap

- Price cap exposes suppliers to the risk that demand (and the corresponding revenue) over the price-quality path is different to that forecasted at the reset
- Revenue cap would transfer this risk away from suppliers (though extent dependent on design)
- Some stakeholders have suggested that reducing this demand forecasting risk to suppliers would be beneficial because:
  - suppliers have a limited ability to control demand volumes
  - it is difficult to accurately forecast future demand
  - unexpected demand changes have a large impact on supplier revenues
- What would be the WACC impact (if any) of this reduced demand risk?

RAB indexation

- Submissions on whether the value of assets in the RAB should increase in line with inflation or not
  - Decision ought to be NPV neutral but affects how quickly the cost of the asset is recovered
  - Does it change the risk profile of investment?
  - Link to emerging technologies discussion
- Secondary related issue is the risk from using a forecast of inflation to determine asset revaluations
  - Hedging effect if using forecasts of inflation on a consistent basis with setting the nominal WACC?
  - What would be the impact of an unindexed RAB?

In summary

Overall risk allocation between suppliers and consumers based on 'Total Package'

- Complete approach to risk allocation should be considered when evaluating potential IM changes
- Some element of judgement required in the trade off between providing appropriate incentives for suppliers and their exposure to risks over which they have less control
- Appropriate compensation for material risk exposure can be determined once risks have been allocated
  - WACC for systematic risk
  - Ex-ante allowances/ex-post compensation for risk management costs when they provide long-term benefits for consumers

Questions

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Questions for discussants to consider:

Do the current risk allocation mechanisms under price-quality paths, as determined by IMs, appropriately allocate risks between suppliers and consumers?

What changes could be made to price-quality regulation that would:

- Reduce the overall risk to suppliers and consumers?
- Change allocation of risk between suppliers and consumers to better promote the long-term interests of consumers?

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