POWERCO

Submission on

Input methodologies review:

Technical consultation update paper

3 November 2016

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1. Introduction

1. This is Powerco Limited's (Powerco) submission on the Commerce Commission's (Commission) consultation paper, *Input methodologies review: Technical consultation update paper*, dated 13 October 2016 (consultation paper).

2. Powerco supports the submission of the Electricity Networks Association (ENA) on this matter.

3. This submission considers:

   3.1 The proposed changes to the cost of capital input methodology (IM), as discussed in the consultation paper

   3.2 Other key policy or drafting issues that arise in relation to the draft IM determinations for electricity distribution businesses (EDBs) and/or gas distribution businesses (GDBs), in particular in relation to:

   - The CPP requirements for EDBs
   - The proposed revenue cap and revenue cap wash-ups for EDBs
   - Asset valuation
   - Cost allocation
   - Recoverable costs

   3.3 Detailed technical comments on the draft GDB IM determination (we support the technical comments made by the ENA on the draft EDB IM determination and do not replicate those comments in this submission).

2. Proposed changes to cost of capital IM

Debt issuance costs

4. The Commission has proposed to remove the notional debt issuance cost allowance from the IMs and instead provide GDBs and non-exempt EDBs with an allowance for their actual debt issuance costs through the operating cost allowance at each price reset.

5. In principle, Powerco should be indifferent as to whether the debt issuance costs are included in WACC or as a building block. Provided the Commission applies debt issuance costs in opex in a way that is neutral to the effect on the price path, the change would be acceptable.

6. Despite this, Powerco is concerned that the methodology to be determined by the Commission will not match actual debt issuance costs of Powerco or other regulated firms and will produce a volatile and uncertain allowance that may be at risk of manipulation. We are also concerned that this proposal has been made very late in the IM review and there is not enough time to properly consider it. We explain these points further below.

7. If the opex amount is determined using an industry-wide gearing assumption (i.e. 41%) then this will be problematic. An EDB's actual gearing does not match (and will never match) the Commission's assumed 41%. The 41% gearing value is reviewed once every seven years and applied across all EDBs.

8. The difference in gearing would result in the debt issuance opex allowance being too low for more highly geared EDBs and too high for lower geared EDBs.

9. If debt issuance costs are included within opex, then IRIS rewards or penalties will apply, exacerbating any 'over' or 'under' provision.

10. If the debt issuance costs are set for future price resets based on historical costs of each EDB, there is a risk of unintended or unrepresentative assessments of the cost. For example:

    10.1 If the observation period for a regulated supplier includes a US Private Placement bond then costs could be unusually high

    10.2 If the observation period included a small and short-term bank facility then costs could be unusually low.

    10.3 As the regulated supplier will make decisions on when to issue debt and on the nature of the debt that is sought, they may face incentives in this regard that are not in the long-term interest of consumers.

    10.4 Even if the observation period was five years, to align with the regulatory period, there is still a possibility of an unusual representation of long-term funding within that period. For example, between 2010 and 2013 Powerco issued predominantly longer term bonds in higher cost markets, for the purpose of lengthening the tenor of Powerco's funding book. This was a consequence of the Global Financial Crisis making these markets unavailable for a few years prior to 2010.

11. The consultation paper argues that the new approach will drive efficiency gains and lower overall costs to consumers. We are not convinced this will be the case:

11.1 If an EDB issued debt at a lower cost, this could reflect a permanent reduction in costs but could equally reflect a particular time period in which costs are lower due to temporary market conditions that will not continue over time.

11.2 Similarly, higher costs may not reflect a permanent increase in debt issuance costs, but prevailing and temporary market conditions.

11.3 Where debt costs appear higher or lower due to differences between actual and notional gearing, this could lead to permanent imbalances between actual and allowable costs, which is not consistent with efficient outcomes.

12. It seems the Commission has been motivated to move debt issuance costs from the WACC into the DPP opex allowance due in part to the difficulty of identifying a robust debt issuance cost allowance that can be included in the cost of capital. However, as highlighted in this submission, the complexity of determining an appropriate debt issuance cost allowance within opex for each GPB, each non-exempt EDB and Transpower at the time of their price resets is likely to be just as challenging and require the Commission to assess historical debt information for 20 different companies. We consider that including the debt issuance cost allowance in the WACC is likely to be less challenging and also more consistent with the intent of a low-cost DPP.

13. Despite these concerns, if the assessment of debt issuance costs is formulaic and the methodology is maintained over time, then there will be certainty for suppliers and consumers regarding the nature of the cost. The difference between the opex allowance and the actual cost (which will be very likely to occur) will then be no different to the status quo, where the actual debt issuance costs of regulated suppliers may differ from the allowance built into the WACC.

14. Even if the other problems can be resolved, we consider that the proposal changes the cost of debt and therefore other aspects of the IMs and this does not appear to have been recognised in the consultation paper. In the IMs, the cost of debt is an input to the following items:

14.1 Notional deductible interest

14.2 The capex wash-up time value of money adjustment for EDBs

14.3 The transmission asset wash up time value of money adjustment for EDBs

14.4 The opex and capex IRIS time value of money adjustments for EDBs

15. By changing the cost of debt calculation by removing debt issuance costs, the Commission is also changing all of these other items. We question whether that is reasonable or intended.

16. The proposal to change the approach to providing for debt issuance costs has been made late in the IM review process and has not previously been considered by submitters. This has made it difficult to reach a clear view on the proposal. Making late changes to the IMs also increases the risk of unintended consequences as there is not enough time for them to be fully scrutinised.

17. Given the concerns about changing the methodology and the absence of compelling evidence to change the IMs, Powerco supports retaining the current debt issuance cost allowance in the WACC IMs at 0.35%.

Historical average approach to estimate the debt premium

18. The consultation paper states that the Commission has not changed its position on using a historical average to estimate the debt premium. However, it has noted strong submissions on this point and is consulting on a methodology to apply a historical average should this be its final decision. This method involves setting the debt premium by:

    18.1 estimating the debt premium using three months of data, consistent with the proposed three month ‘prevailing approach’ put forward in the draft decision

    18.2 making this estimate each year and using the average of the five most recent estimates to develop the debt premium estimate for the WACC.

19. Powerco considers the proposed historical average method is an improvement on the current ‘prevailing rate’ methodology. However, we note the concerns raised by the ENA submission on this topic.

3. CPP requirements for EDBs

Mid-CPP period WACC reset

20. Powerco supports the approach of setting the CPP WACC to match the DPP WACC, with a mid-period reopener to the CPP price-path to account for a change in the DPP WACC during the CPP. As previously discussed with Commission staff, we have a recommendation for improving the proposed mid-CPP period WACC adjustment.

21. The IMs expect that the current DPP WACC (presently 7.19% from FY2016 to FY2020) should be applied, for the purposes of a CPP application and initial CPP price decision, for the full five year period of the CPP.

22. We recommend the IMs instead provide that a CPP application would:

    22.1 apply the prevailing DPP WACC (currently 7.19%) for the years of the CPP that fall in the current DPP regulatory period

    22.2 then apply an updated forecast WACC (determined consistent with the requirements of the new IMs) for the years of the CPP that fall in the next DPP regulatory period.

23. In either case, the CPP determination would be reopened when the new DPP WACC is set for the next DPP. The benefit of our recommendation is that where, at the time the CPP application is made, interest rates are expected to be higher or lower than when the previous DPP WACC was set, this expectation can be built into the CPP WACC. This will most likely set a CPP WACC that is closer to the WACC for the next DPP regulatory period and thus deliver a smaller price adjustment following the reopener.

24. In contrast, the current drafting of the IMs would most likely deliver a greater divergence between the CPP WACC and the WACC for the next DPP regulatory period. In our view this adds price volatility and uncertainty into pricing and signals to customers a price increase which is larger or smaller than up-to-date forecasts (i.e. forecasts at the time of the CPP application) consider is likely.

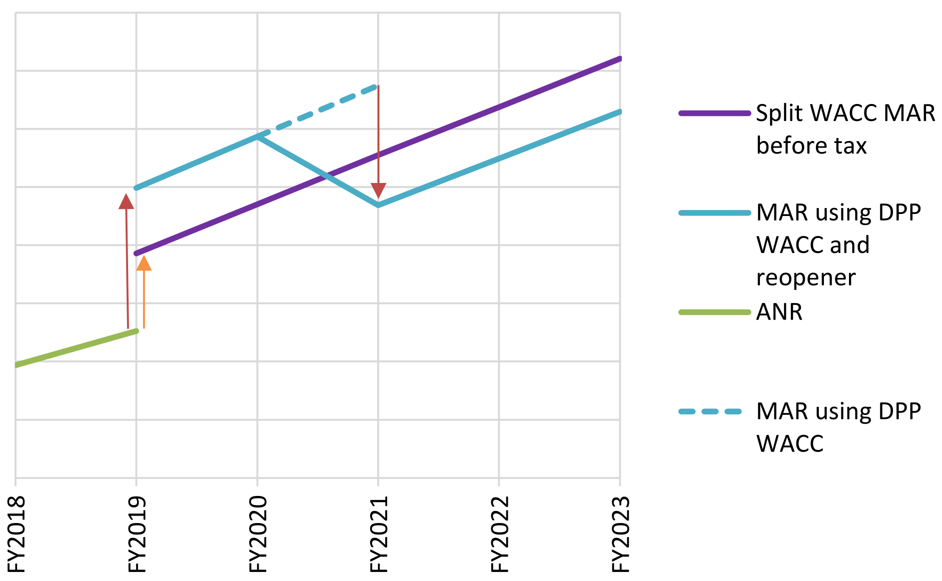
25. The result of our recommended approach would be:

25.1 a more realistic forecast of a CPP's price impacts when the CPP application is made and consulted on.

25.2 most likely a smaller reopener adjustment when the DPP WACC is reset, which creates a better outcome for consumers through more stable prices.

25.3 no change for the CPP applicant in NPV revenue terms as they receive the same NPV of revenues under either approach but consumers face more price volatility under a single WACC approach.

26. The following chart illustrates the effect of the two approaches if there is a decrease in DPP WACC in FY2021. In this case using only prevailing 7.19% WACC in a CPP application, prices increase significantly when moving to the CPP in in FY2019 (represented by the first red arrow) then decrease significantly in FY2021 through the reopener (the second red arrow). In contrast, a CPP application using a forecast of WACC for FY2021 to FY2023 results in a lower increase in FY2019 starting prices (represented by the orange arrow) and a smaller impact on FY2021 starting prices arising from the reopener (shown as nil in this example).



27. We consider that our recommendation could be implemented in the CPP IMs by amending clause 5.3.22(1) to read as follows (changes in bold, additions underlined and deletions struck-through):

(1) The cost of capital for a CPP is**<u>:</u>**

<u>(a) for the years of the CPP regulatory period that fall within the DPP regulatory period applying at the start of the CPP regulatory period,</u> the cost of capital determined in accordance with the methodology identified in clause 4.4.1 for **<u>that</u>** **~~the~~** DPP **~~applying at the start of the CPP regulatory period~~<u>; and</u>**

<u>(b) for all subsequent years of the CPP regulatory period, a forecast of the cost of capital for those years developed by [the Commission / the CPP applicant] in accordance with the methodology identified in clause 4.4.1 with all modifications necessary to develop the forecast.</u>

28. Powerco does not have a strong view as to whether the forecast cost of capital required under our suggested subclause (b) would be developed by the applicant or by the Commission. There are advantages and disadvantages of each approach:

28.1 If the forecast was developed by the Commission, this would require up-front work by the Commission before the CPP is submitted. It may effectively require the Commission to continue to publish a form of CPP WACC determination each year. However, it would remove any doubt or debate as to the WACC that is to be used in the CPP application.

28.2 If the forecast was developed by the CPP applicant, we expect this would be scrutinised by the Commission during the CPP application process. It would avoid up-front work by the Commission but create an additional task for the Commission when reviewing an application.

29. We note that if the forecast was developed by the CPP applicant, the applicant will be motivated to develop a robust cost of capital forecast. The applicant will want the forecast to be accurate as this will minimise the size of the mid-period price reset or, ideally, avoid the reset altogether if the forecast is perfect.

30. We also note that using a forecast of WACC for a future DPP regulatory period should encompass reforecasting inflation in order to preserve the natural hedge against inflation in the IMs. Updating forecast inflation would be beneficial as the current DPP approach is not intended to extend beyond a single DPP regulatory period.

Regulatory tax asset value by category

31. Powerco continues to recommend the removal of the requirements to provide regulatory tax asset value information disaggregated by asset category (clauses 5.4.22, 5.4.25 and 5.4.26). Providing this information is costly and complex for the business and does not appear to add any value to the Commission or the verifier when assessing a CPP proposal.

32. Powerco strongly requests the Commission removes these requirements from the IMs and instead permits businesses to provide regulatory tax asset value information in the aggregate. If these requirements remain in the IMs, the Commission should explain why they are necessary and why the value of this information is proportionate to the cost of providing it.

4. Revenue cap and wash-up arrangements for EDBs

Cap on wash-ups for catastrophic events

33. The Commission has now clarified that the cap on the wash-up amount will be 20% (i.e. the revenue cap will not permit wash-ups of negative demand shocks such as catastrophic events where the revenue impact is greater than 20%). It is helpful for the Commission to specify this level in the IMs and 20%, while arbitrary, seems reasonable. We agree the 20% cap should be based on regulatory revenue excluding pass-through and recoverable costs.

Wash-up for pass-through balance

34. The wash-up amount does not appear to include any costs from prior to the start of the revenue cap method on 1 April 2020. We consider that it needs to include any outstanding pass-through balance from the current regulatory period or any over-recovery of pass-

through costs will not be returned to consumers and any under-recovery will be permanently lost by the EDB.

Mandatory draw-down in favour of consumers

35. The proposal to require a mandatory draw down of the wash-up account balance where that is favourable to consumers is reasonable, but there is a need to clarify that this applies to known wash-up values only. Clause 3.1.3(13)(h)(ii) requires that where the wash-up balance is

> *"a net excess amount of actual revenues over actual allowable revenues in respect of earlier disclosure years, the amount drawn down shall be such that the balance of the wash-up account is reduced to nil in respect of* ***each*** *earlier disclosure year." [emphasis added]*

36. It would be helpful to clarify that "each earlier disclosure year" only refers to years that have ended and for which the final difference between actual revenues and actual allowable revenues is known at the time of setting prices.

5. Asset valuation

Accelerated depreciation

37. The way the accelerated depreciation provision has been drafted (EDB IM determination clause 2.2.8(4)) it appears that if a Commission approved accelerated depreciation of up to 15% it would do this for all existing assets held by the EDB. We question both whether this is the intent and whether it is sensible.

38. The problem definition identified the risk of emerging technologies changing the risk of EDBs' ability to fully recover their invested capital.[1] We support this intent but note that this risk will not be uniform across a network but will vary depending on the location and nature of each asset. Rather than applying accelerated depreciation across all assets, it would be more sensible (and more explicable to interested parties) if this was applied to the assets that are at significant risk of stranding due to emerging technologies. For these assets, the accelerated depreciation rate could reasonably be higher than 15%.

Easements

39. Powerco continues to recommend the Commission amend the Input Methodologies definition for commissioned assets in relation to easements (clause 2.2.11(1)(b)). For the reasons outlined in our previous submission,[2] the IMs should specify that commissioned, in relation to easement rights, means the year in which the rights are acquired, not when the underlying assets themselves are commissioned. This would bring the IMs into line with the original IM Reasons Paper and better reflect prudent business practice which is to acquire easements ahead of time to ensure they are available when needed.

[1] Commerce Commission, "Input methodologies review draft decisions – Topic paper 3 – The future impact of emerging technologies in the energy sector", 16 June 2016, paragraph 73.
[2] Powerco, "Submission on Input Methodologies Review Draft Amendment Determinations", 18 August 2016, paragraphs 32-35.

6. Cost allocation

OVABAA

40. As discussed in submissions on the recent cost allocation update paper, if ACAM is removed from the IMs the OVABAA methodology should be reviewed with the aim of simplifying the methodology. We do not make drafting recommendations for OVABAA in this submission as this topic cannot be properly considered in the time available before the final IM decision in December.

The new cost allocation IM should not apply to the 2017 gas DPP reset

41. Powerco was surprised by clause 1.1.2(6) of the draft gas distribution IM determination as it contradicts the statement made in the recent cost allocation update paper. That paper said:[3]

> *"We propose introducing the proposed changes to the cost allocation IM to apply to both EDBs and GPBs for information disclosure purposes from (and including) the 2018/19 disclosure year. These changes would therefore affect default price-quality paths set… for GPBs from the 2022 reset. Changes would affect customised price-quality paths that take effect in or after 2020 for either EDBs or GPBs."*

42. This makes it clear that the removal of ACAM would not affect gas DPP price paths until 2022. This is reasonable as there is insufficient time to develop and apply a new cost allocation methodology to inform the 2017 reset, where a final decision will be made just a few months after the new IMs are determined.

43. As the Commission has already stated the new cost allocation IMs will not apply to price-quality paths until 2022 for DPPs, it is not clear why clause 1.1.2(6) is required. This clause states:

> *"For the avoidance of doubt, if the Commission determines that any forecast values are required to be calculated consistent with the input methodologies relating to cost allocation in Part 2, Subpart 1 for the determination of a DPP that is to come into effect after the commencement date of this amendments determination, the amendments to the input methodologies in respect of cost allocation, and any amended definitions in clause 1.1.4(2) will apply at the time when the Commission requires the forecast information."*

44. It is not plausible that the Commission will require information for determining the 2022 gas DPP reset before the new cost allocation IM has come into effect on 1 October 2018. Therefore we cannot see how this clause could be used given the Commission's undertaking not to apply the new cost allocation IM at the 2017 gas DPP reset. As this clause appears to serve no purpose we recommend it is deleted.

7. Recoverable costs

EDBs: Extended reserves

45. The extended reserves recoverable cost in the EDB IM determination is becoming more relevant as the Electricity Authority moves closer to fully implementing the new extended

[3] Commerce Commission, "Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses", 22 September 2016, paragraph 42.

reserves scheme. The drafting in the determination appears incorrect. Clause 3.1.3(7) states:

> *For the purpose of giving approval under subclause (2) in respect of an extended reserves allowance, the Commission will have regard to any policy intent stated by the Electricity Authority as to whether–*
>
> > *(a) some or all compensation payments to be made by an EDB under the extended reserves regime would be expected to constitute negative recoverable costs and be passed-through to consumers via corresponding reductions in prices; and*
> >
> > *(b) revenues that an EDB may receive under the extended reserves regime would be expected to be treated as unregulated income.*

46. If compensation payments are made by an EDB under the extended reserves scheme to another transmission customer (who could be an EDB or a direct connect customer of Transpower) this will be because that EDB and its consumers face lesser extended reserves obligations than the other transmission customer. In this circumstance the EDB and its consumers will have benefited from fewer extended reserves outages compared to the other transmission customer.

47. Therefore subclause (a) of the definition is wrong as any compensation payments made by an EDB would be a positive recoverable cost for that EDB and the EDB would recover the cost from consumers. It is appropriate for the EDB to recover the costs of this compensation payment from its consumers as they are the parties that directly benefited.

48. In the reverse situation, where an EDB receives a compensation payment from an EDB it is appropriate to treat this as a negative recoverable cost as the means by which the EDB can allocate the compensation payment to its consumers (who are the parties that have 'lost' by providing a higher level of extended reserves).

GDB ascertainable approach

49. Following submissions, the Commission's proposal now is to retain the current 'ascertainable approach' for determining pass-through and recoverable costs. We welcome this position and that the Commission has taken account of submissions on this point.

8. Technical drafting points for the GDB draft IM

50. As noted in the Introduction section of this submission, we support the detailed technical comments made by the ENA in relation to the draft EDB IM determination

51. Table 1 sets out our comments on the technical drafting of the draft GDB IM determination.

Table 1: Clause-by-clause commentary on draft GDB IM determination

Reference	Description of issue
Definition of term credit spread difference	The definition references clauses 2.4.8 and 4.4.9. This should instead reference 2.4.8(1) and 4.4.9(1).
Definition of term credit spread	The definition reference clause 4.4.8(1). This should instead

Reference	Description of issue
differential	reference clauses 4.4.8.
Definition of capital contribution	The term "acquisition" has been added to this definition but should be removed. We cannot see how a capital contribution would be received or requested in the case of an asset acquisition.
1.1.2(4)(b)	This clause seems incorrect. The new information disclosure IMs (except cost allocation) should come into effect for the 2018 disclosure year, as stated in paragraph 58 of the consultation paper. There is no basis to link the disclosure IMs to a DPP or CPP determination and the wording "the first disclosure year of each DPP" is confusing for gas businesses where disclosure years and pricing years do not always align.
1.1.2(6)(f)	As discussed in the cost allocation section of this submission, this clause should be deleted.
2.1.1(4)(a)-(b)	It should be clarified that the limit to not allocating more than could be allocated under ACAM applies to OVABAA only. Otherwise the implication could be that all GDBs need to apply ACAM as a check every time they apply ABAA. These subclauses should be amended as follows: (a) operating costs that may be allocated <u>under OVABAA</u> to gas distribution services and other regulated services, in aggregate, must not exceed the total value of operating costs; and (b) regulated service asset values that may be allocated <u>under OVABAA</u> to gas distribution services and other regulated services, in aggregate, must not exceed the total regulated service asset values,
2.1.3	This clause states that under ABAA asset values and operating costs may be allocated to gas distribution services and other regulated services. The clause should also state that asset values and operating costs may be allocated to unregulated services under ABAA.
2.1.3(3)-(5)	These subclauses do not fit well within the IMs. We consider that these requirements are better suited to the information disclosure determinations and should be included there only.
2.1.5	This clause sets out how ACAM must be applied but does not specify the circumstances in which it can be used. We suggest adding the following wording at the beginning of the clause: "For the purpose of determining that OVABAA allocations meet

Reference	Description of issue
	the requirement specified in clause 2.1.1(4)…”
2.2.11(b)	As discussed above, the definition of “commissioned”, in relation to easements, should mean the year in which the rights are acquired, not the year that the underlying assets are commissioned.
3.1.1(4)	The reference to ‘posted’ has been removed from the definition of price. We question whether this was intended. This change has been proposed for EDBs as part of their move to a revenue cap form of control, which is not rationale that can be applied to GDBs. No explanation for removing this term from the GDB determination is provided in the consultation paper.
3.1.3(4)(b)	This subclause provides that an urgent project allowance can be applied where net costs would not be “included in a value of commissioned asset”. We recommend that this clause instead refers to costs that “will not be otherwise recovered by the GDB”. This clarifies the intent of the clause and avoids a situation where capital costs that would not otherwise be recovered may not be included in an urgent projects allowance.
3.1.3(6)(a)	This clause states that the discount rate for the capex wash-up must be determined by discounting BBAR “to the end of the preceding DPP regulatory period”. This seems to have been drafted with DPP capex wash-ups in mind. It does not work for CPP capex wash-ups because, for a CPP we assume the intent is not to discount to the end of the previous DPP regulatory period, but to the point in the current DPP regulatory period at which the CPP began.
4.2.3(4)(a) and 5.3.4(11)(a)	These clauses refer to paragraphs (b) and (c) of the definition of CPI, but the paragraph (b) that is referred to has now been deleted from the definition.
4.5.2(e)	Clause 4.5.1 helpfully clarifies that the 1% materiality threshold for catastrophic event reopeners should be assessed using costs that have been and will be incurred. The same clarification should be applied for change event reopeners in this clause (i.e. the words “has had or will” should be included in this clause).
4.5.4	This new clause provides that price-quality paths may be reopened following a major transaction. We agree this may be necessary. However, the clause defines major transactions as those in which consumers are transferred between suppliers of the same type of regulated service. This implies that reopeners are not available following transactions between a regulated supplier and an unregulated provider of the same service (e.g. between a large embedded network, or between regulated and

Reference	Description of issue
	unregulated gas pipelines). This is too narrow. A regulated GDB could conceivably enter into a transaction with a non-regulated supplier of gas pipeline services and the effect of this on the GDB could be similar, or even larger, than a transaction with another GDB. We consider that a major transaction should be defined in terms of the impact on the regulated supplier, not on the regulatory status of their counterparty in the transaction. The major transactions reopener should therefore apply to any transaction in which the GDB acquires or disposes of consumers.

Thank you for the opportunity to comment on the *Input methodologies review: Technical consultation update paper*. If you wish to discuss any of the points made, or clarify any matters, in the first instance please contact Lynette Taylor tel. (06)968 6235, email Lyn.Taylor@powerco.co.nz.

Yours sincerely

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