MAJOR ELECTRICITY USERS' GROUP

10th July 2015

Keston Ruxton
Manager Market Assessment and Dairy, Regulation Branch
Commerce Commission
By email to IM.Review@comcom.govt.nz

Dear Keston

Comments on CPP fast track

1. This letter provides feedback by the Major Electricity Users' Group (MEUG) on the Commerce Commission paper[1] "Input Methodologies review process paper, Update on fast track amendments" dated 3rd July 2015. The Commerce Commission have asked for feedback in particular on the proposal by Powerco, Electricity Networks Association and Wellington Electricity Line Ltd to fast track, rather than include in the review of all other Input Methodologies (IM), consideration of a substantial amendment to allow Customised Price-Quality Path (CPP) applications to use the Weighted Average Cost of Capital (WACC) set in the last Default Price-Quality Path (DPP) determination.

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential.

3. Powerco suggest the determination of WACC to be used for CPP applications is severable from consideration of all other IM and can therefore be considered in a separate fast-track process. MEUG disagrees. WACC is a core subject across topics 1 to 5 as listed in the Commerce Commission's Invitation to contribute to problem definition paper of 16th June 2015. Those topics are:

   Topic 1: Risk allocation mechanisms under price-quality paths;

   Topic 2: The form of control for price-quality regulated sectors;

   Topic 3: Interactions between the DPP and CPP;

   Topic 4: The future impact of emerging technologies in the energy sector; and

   Topic 5: Issues raised by the High Court on cost of capital.

4. Some but not all of these topics are on the agenda for the Commerce Commission forum on 29th and 30th July. MEUG understands the purpose of the forum is to tease out a clear

[1] URL's http://www.ea.govt.nz/dmsdocument/19497 and http://www.ea.govt.nz/dmsdocument/19498 at http://www.ea.govt.nz/development/work-programme/transmission-distribution/transpower-tpm-operational-review/consultations/#c15388

Level 1, 93 The Terrace, Wellington 6011, New Zealand
PO Box 8085, The Terrace, Wellington 6143, T +64-4 472 0128, info@meug.co.nz , www.meug.co.nz

definition of problems where at the moment it is unclear exactly what possible problems there might be with the existing IM. We are not anticipating an extensive discussion at the forum on WACC because the problems are reasonably well known and in any case we intend to elucidate further details when making submissions by 21st August 2015.

5. Solutions to the problem of what WACC should apply for CPP applications cannot be found without considering all other elements of the five topics listed above. The following two paragraphs provide examples of the interrelationship of WACC and the overall IM package that could affect the WACC for CPP applications.

6. First we refer to MEUG's letter to the Commerce Commission last Tuesday providing details on Black's discounting rule including a paper by Loderer at al. That letter followed up on MEUG's submission of 20th March 2015 that mentioned Black's discounting rule may be of interest in relation to problems with the cost of capital IM. A copy of the recent MEUG letter and article by Loderer et al. is attached to this feedback. Using the approach of Loderer et al. it would be possible to consider whether the derived valuations of price paths for Transpower's IPP, the DPP for non-exempt distributors and be-spoke CPP's aligned with price paths set using WACC based on the Simplified Brennan-Lally Capital Pricing Model (SBL CAPM). If alignment was poor this would lead to questions as to the application of WACC using SBL CAPM and Black's discounting rule. It is possible such an approach will result in WACC for IPP, DPP and CPP being different consistent with, for example, the intuition that Transpower's regulated line services are essentially risk free or at least less risky than distributors regulated line services. MEUG intends to include the use of Black's discounting rule as an important alternative and or cross check on WACC in submissions due 21st August 2015. Fast-track consideration of the WACC for CPP applications is therefore contrary to the direction MEUG sees the discussion on cost of capital IM developing.

7. Second we understand the potential disincentive Powerco faces with the current regime whereby the WACC to be used in a CPP application in May 2016 will be less than the WACC set in the last DPP determination on 28th November 2014. However there are wider conceptual issues and details that need to be considered such as:

- An alternative would be to use a split WACC whereby the return on new investment added to the Regulated Asset Base (RAB) specifically applicable to the CPP is at the expected lower WACC for a CPP application next year thereby keeping whole the return on existing assets in the RAB at the existing DPP WACC. That alternative would also have to consider whether symmetry should be kept in the scenario where WACC was increasing and a CPP application should use the higher WACC only for the return on new investment added to the RAB specifically applicable to the CPP and all existing RAB would receive the existing and lower DPP WACC.

  Paragraph 125 of the Commerce Commission Invitation to contribute to problem definition paper illustrates how a symmetrical treatment of forecast compared to actual inflation needs to be considered. Understanding and testing this symmetry in relation to WACC to be used for CPP applications is not trivial and cannot be separated from consideration of changes to improve all IM.

- The Powerco submission provided an indication of the materiality to the company of the status quo but we have no idea of the materiality of potential benefits to consumers. For example we have no view as to whether a CPP application by Powerco adopting their proposed CPP WACC will change price paths for their customers by more than 1%. If so then that is a material change[2] and will require

[2] For this feedback MEUG has assumed a 1% change in price or revenue path as a threshold for a material change because it is equivalent to the 1% of aggregated allowable notional revenue used as a de minimus for considering changes to CPP for catastrophic events, change events or errors (Electricity Distribution Services IM 2012, subpart 6) and

detailed (not a fast tracked) consideration of the trade-offs and compromises. MEUG is prepared to be pragmatic but we are not in favour of a process that may have material effects that we are unaware of and establishment of precedents contrary to the direction needed for better outcomes on WACC for CPP, DPP, IPP and Information Disclosure.

- Powerco made decisions to hedge debt exposure for Regulatory Control Period 2 based on the DPP determination of November 2014 including the WACC in that determination. There is an important design question around why consumers should in effect underwrite Powerco's debt policies should the CPP WACC proposal be adopted when if a contrary scenario had occurred consumers' cannot exercise an option to apply for a CPP which may realise windfall gains on debt policies and WACC settings. Again there is a matter of understanding what and whether symmetry in design is important. These are not trivial issues capable of resolution in a fast-track process.
- The Powerco proposal is made subsequent to the change to the 67th WACC percentile and after the Orion CPP determination. Implications of a potential change in the business risk (asset beta) component of WACC need to be considered. The asset beta of 0.34 reflects the current regulatory settings and assumptions (i.e. risk allocations). To the extent that systematic risk is affected by the proposed regulatory changes the asset beta of 0.34 would be expected to decrease to reflect the reallocation of risk between suppliers and users. In paragraph 10 Powerco has explicitly "priced the risk" at $12.1 million pa reflecting a change from the allowed DPP WACC of 7.19% and a current CPP of 6.35%. Changing the regulatory rules as proposed re-allocates risk but Powerco is silent on any consequential adjustment needed to returns.

8. For completeness and to anticipate that the CPP WACC will be an issue in the wider review of IM MEUG notes that the comments above are not intended to be a comprehensive commentary on factors to be considered.
9. It may be following the IM review no major changes are made to the cost of capital IM and indeed the solution proposed by Powerco for the CPP WACC is adopted. The downside in that case is that there will have been a one year delay to Powerco's preference to submit a CPP application by May 2016 and consumers may have benefits delayed by one year. MEUG believes any risk of forgoing any claimed benefits from an earlier decision on the WACC for CPP applications is outweighed by using the full IM review to address broader and more material problems in the cost of capital IM.

Yours sincerely

Ralph Matthes
Executive Director

Attachments:

MEUG letter to Commerce Commission, Black's simple discounting rule material, 7th July 2015

Claudio F. Loderer, John B. Long, and Lokas Roth, Black's Simple Discounting Rule, August 2008, last revised in 2013

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similarly a 1% change in forecast Maximum Allowable Revenues for Transpower's IPP is used in Transpower IM Determination [2012] NZCC 17, 29th June 2012, Subpart 7.