



**Submission on**

**Input methodologies review:  
Invitation to contribute to problem definition**

**Date: 21 August 2015**

## 1. Introduction and summary

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1. Thank you for the opportunity to comment on the Commerce Commission's input methodologies (*IMs*) review problem definition paper. Powerco welcomes the opportunity to comment on the matters that the Commission has raised. This submission responds to the following documents:
  - 1.1 *Input methodologies review: invitation to contribute to problem definition* (16 June 2015) (**problem definition paper**);
  - 1.2 *Developing decision-making frameworks for the current IM review and for considering changes to the IMs more generally – discussion draft* (22 July 2015); and
  - 1.3 *Input Methodologies review process paper: update on CPP fast track amendments* (7 August 2015).
2. Enclosed with this submission is a report from HoustonKemp<sup>1</sup> that responds to several specific proposals in the Commission's problem definition paper. That report forms part of our submission. This submission also incorporates our previous submissions of 23 June 2015 and 10 July 2015.
3. We have reviewed in draft the Electricity Networks Association's (**ENA**) submission in response to the Commission's problem definition paper. We support the points made by ENA in its submission.
4. The Commission's initial 'long list' of possible problems to be addressed and the associated commentary in the paper serve as a useful guide to the potential scope of the review.
5. The Commission correctly identifies that it is required to review all IMs within the scope of the notice of intention. However, we do not think that precludes the Commission from using this problem definition phase to narrow its focus and identify those issues that warrant particular detailed consideration and those that do not. In our view, the Commission is adequately discharging its obligation to review all the IMs within the scope of the notice by conducting this problem definition phase, including the forum. It follows that the Commission can now move on to identifying and investigating the priority issues and developing options for amending the IMs.
6. The Commission has outlined a number of criteria that it proposes to use to determine which of the IMs it should consider changing. We agree that those criteria are an appropriate starting point, but propose in addition some practical questions that we think should also guide the Commission's approach.
7. Applying the criteria, there are:
  - 7.1 a number of proposals in the Commission's problem definition paper that should clearly be taken forward;
  - 7.2 several issues that, while they may warrant public debate as part of the IMs review process, the Commission should consider very carefully before implementing any changes; and
  - 7.3 a number of proposals that can be definitively ruled out at this stage of the process.
8. We summarise our views in the table below. A more detailed elaboration of Powerco's response to the Commission's questions on individual topics can be found below.

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<sup>1</sup> HoustonKemp "Comment on the Commerce Commission's Input Methodology Review: a report for Powerco" (20 August 2015).

**Table 1: Summary of Powerco submission**

Issue	Comment
<b>Proposals that should clearly be taken forward</b>	
Allowing greater flexibility in the depreciation profile (topic 1)	The Commission's current approach to RAB indexation results in delayed recovery of capital, which affects cost of capital and investment incentives. The Commission should consider allowing greater flexibility in the depreciation profile as an alternative to revising its approach to RAB indexation.
Alignment of DPP and CPP WACCs (topic 3)	As the Commission has identified, the misalignment between the DPP and CPP WACCs creates the wrong incentives for suppliers that may be considering applying for a CPP. Aligning the DPP and CPP WACCs is a straightforward solution that would solve this problem for the upcoming CPP application windows. If the Commission is unable to address this issue adequately as part of the fast-track process, it should transfer it to the full IM review.
Revision of the methodology for estimating cost of debt (topic 5)	<p>We agree with the Commission's proposal to revisit the methodology for estimating the cost of debt, particularly because the current methodology does not align with the prudent and efficient debt-raising strategies used by comparable unregulated businesses. We recommend that the Commission consider adopting a 10-year, rather than 5-year term for cost of debt, and adopt a trailing average methodology that involves annual updating of the WACC on the basis of a rolling average of the cost of debt (rather than a one-month average estimate observed at the outset of the regulatory period).</p> <p>In addition, the Commission should consider providing for several ancillary costs associated with raising and managing debt that are currently uncompensated by the IMs: cost of headroom, cost of carry, and hedging costs.</p>
Improvements to the CPP IM to reduce cost and complexity of CPP applications and CPP compliance (topics 8 and 9)	Reducing unnecessary cost and complexity in the CPP IMs is a positive sum game. Reducing cost and complexity improves the efficiency of the Commission's decision-making, and mitigates the chilling effect that cost and complexity have on suppliers' decisions to apply for a CPP.
<b>Issues that warrant further public debate and which should be kept in scope</b>	
Inappropriate or inconsistent incentives produced by the treatment of CPI (topic 1)	The various cashflow and real revenue implications of the ways in which the Commission's CPI forecasts are effectively incorporated into the DPP and CPP price paths, including via asset revaluations, should be reviewed.
Moving from weighted average price control to revenue control (topic 2)	This proposal has pros and cons, but particularly requires consideration given the likelihood that accurate demand forecasting will become more difficult in the future due to the introduction of new technologies. We support an objective and balanced discussion of this issue.
Single issue CPP applications (topic 3)	The CPP process, as currently conceived, is disproportionately costly in circumstances where suppliers require a departure from the DPP that is limited to a single, discrete and clearly defined issue. The

	Commission should consider amending the DPP or CPP IMs to allow for single-issue departures from DPPs.
Implications of emerging technologies (topic 4)	We agree that emerging technologies have the capacity to dramatically alter the commercial landscape for EDBs. This may require consequential amendments to the IMs. However, the nature of the likely implications of new technologies for the market, and the timing of those developments, is currently unclear. Consequently, while it is appropriate for the Commission to consider these issues, we think it will prove inadvisable to make any substantial amendments, in response to changing technologies, as part of this IM review cycle.
<b>Proposals that can be definitively ruled out</b>	
Reliance on the simplified Brennan-Lally CAPM (topic 5)	While the SBL-CAPM has acknowledged flaws, it has been intensively debated prior to this review. There is no new information that would support re-opening this issue.
WACC percentile for electricity lines and gas pipelines businesses (topic 5)	The Commission has recently revisited the WACC percentile for EDBs and gas pipeline businesses. Consequently, there is no case for revisiting this issue after such a short time interval. The certainty objective in s 52R should prevail.
Introduction of a split-WACC approach (topic 5)	MEUG's split-WACC proposal is based on flawed premises and would represent a fundamental change to the WACC methodology. The Commission's criteria for reviewing IMs, as supplemented in the way we suggest below, militate against further consideration of this issue.
Adjustments to asset betas on the basis of form of control (topic 5)	Moving from WAPC to revenue control does not alter the systematic risk faced by the regulated business, and consequently should not require any amendment to the asset beta.

## 2. Decision-making framework

9. We support the Commission's decision to define the focus of its IMs review through an initial problem definition phase. The Commission has correctly identified that it is required to review all IMs within the scope of the notice of intention. However, we think that the Commission is adequately discharging its obligation to review all the IMs within the scope of the notice by conducting this problem definition phase, including the forum. Section 52Y requires a review of the IMs, but it does not require the Commission to determine afresh all of the issues that were addressed in the original determinations. An approach that seeks to first identify those issues of genuine concern, in order to ensure the efficient use of time and resources, is therefore both consistent with the Commission's obligations under section 52Y of the Commerce Act 1986 (*the Act*), and most likely to lead to durable solutions that promote the purposes of the Act and contribute to regulatory certainty. As the Commission notes in its problem definition paper, the IM review will be most effective and efficient if the issues drive the process.<sup>2</sup>
10. Accordingly, we think it was appropriate for the Commission to cast the net wide in its invitation paper. The resulting engagement with the Commission – including the helpful discussions at the forum – has served to flush out many of the issues that will be the

<sup>2</sup> Commerce Commission "Input methodologies review: invitation to contribute to problem definition" (16 June 2015) at [4].

focus of the remainder of the process. Critically, those discussions have also demonstrated that some of the topics in the Commission's invitation paper are of lower priority, in the sense that either: (i) the status quo is adequate, (ii) the issue does not present itself as an immediate problem warranting consideration in this review period, or (iii) the problem does not permit clear definition, and consequently the Commission would struggle to identify a solution (in the available time) that better meets the objectives of the Act.

11. We therefore support the Commission narrowing its focus in the wake of this problem definition phase, and prioritising a tighter range of issues and proposals for further consideration.
12. In its paper on developing decision-making frameworks,<sup>3</sup> the Commission outlines five focus questions that it proposes should govern its assessment of which IMs it should consider changing:<sup>4</sup>
  - 12.1 Is the policy intent behind the IM still relevant and appropriate?
  - 12.2 Is the current IM achieving that intent?
  - 12.3 Could the current IM achieve the policy intent better?
  - 12.4 Could the current IM achieve the policy intent as effectively, but in a way that better promotes s 52R or reduces complexity or compliance costs?
  - 12.5 Do changes to other IMs require any consequential changes to the IM in question for internal consistency or effectiveness reasons?
13. These criteria are an appropriate starting point for the process of narrowing the problem definition paper down to those issues and proposals of genuine concern. However, we do not think this analysis precludes the Commission from taking into account further criteria when deciding whether or not to take an issue forward. In addition to its enumerated focus questions, the Commission should also consider the following:
  - 13.1 the importance of promoting certainty for suppliers and consumers as a regulatory objective in and of itself, as required by section 52R;
  - 13.2 whether the Commission will be able to obtain the necessary information to enable it to form a reasoned and well-supported decision;
  - 13.3 whether circumstances have changed, or new information has emerged, that would justify revisiting issues that have already been extensively debated;
  - 13.4 whether there is likely to be a practicable solution that can be delivered within the limited timeframe; and
  - 13.5 whether it is appropriate to address the issue (and implement any changes) in this review period, or whether it would be more appropriate to address the issue in a future review period.

### **Promoting certainty**

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<sup>3</sup> Commerce Commission "*Developing decision-making frameworks for the current IM review and for considering changes to the IMs more generally – Discussion draft*" (22 July 2015)

<sup>4</sup> *Ibid* at [8].

14. Section 52R expressly directs the Commission to have regard to the need to promote certainty for suppliers and consumers. Certainty, in the context of the IMs, is intended to provide conditions that incentivise investment by suppliers, in the long term interests of consumers. Powerco therefore endorses a principle of incremental rather than wholesale change. The Commission is well aware of the disruptive effects of regulatory change, and conversely the benefits to both consumers and suppliers of predictability and certainty. Predictability and certainty in regulatory arrangements incentivise investment and reward long-term planning, both of which are of critical importance to consumers.
15. When considering whether or not to pursue an amendment, the Commission should therefore bear in mind that the objectives of the Act may be best served by maintaining the status quo. The rationale for implementing a change to the IMs must be weighed against the inherent value of preserving a stable status quo, and sending a signal that the IMs should not be lightly changed.

#### **Availability of necessary information**

16. In order to arrive at a reasoned and well-supported decision – one that the Commission can confidently say is an improvement to the status quo in terms of the focus questions it has set for itself – the Commission must have the necessary information to enable it to:
  - 16.1 define precisely the nature and extent of the problem, and its implications for the regulatory framework; and
  - 16.2 understand the consequences of the changes to the IMs that are proposed to address the issue.
17. Where the Commission is not confident that the necessary information will be available to support its decision-making – either because the problem is not well-understood, or it depends on market developments, the nature or timing of which are uncertain – then it may be an inefficient use of resources to pursue that issue in the context of this review.

#### **Changed circumstances / new information**

18. The original IMs determinations followed a lengthy and intense process of consultation, with a high level of consumer and supplier engagement and detailed involvement from a range of experts. The appeals against the determinations then provided a further opportunity for close scrutiny of the Commission's regulatory choices. Although there are aspects of the final outcome that are unsatisfactory, we must nonetheless acknowledge that the IMs are the result of a detailed debate in which the views of all stakeholders were tested.
19. The Commission should therefore be wary of re-opening some of the more contested elements of the IMs. While stakeholders would almost certainly take the opportunity to express their positions, if invited to do so, it is likely that all the Commission would achieve is a re-litigation of the same issues. Accordingly, when deciding whether to change an IM in response to a concern that has been the subject of previous discussion, the Commission should consider whether or not circumstances have changed, or new information or reasons are advanced, that would warrant looking at the issue afresh (as opposed to simply a re-litigation of views that have already been aired).

#### **Delivering a practicable solution**

20. It is critical that the Commission deliver durable solutions that represent a clear improvement to the status quo. The Commission should therefore consider whether or not it is likely to be able to deliver a practicable solution, in light of the nature of the

problem, the range of proposed solutions, the applicable timetable and the resources available. If it is apparent from the outset that the Commission is unlikely to be able to deliver a practicable solution within the timetable, then that would be a reason to de-prioritise the issue for this review process.

### Timeliness

21. Finally, the Commission should consider whether this review process is the most appropriate time to be considering an issue, or conversely whether it would be more appropriate to address the issue in a future review. The Commission might decide that consideration of an issue is not timely if the issue depends on market developments that are uncertain, or unlikely to crystallise before the next opportunity to review the IMs.

### Conclusion

22. Applying these criteria to the Commission's problem definition paper, it follows that some topics can be foreclosed at an early stage. Table 1 above summarises our views on which issues the Commission should take forward, and which it should not. The remainder of this submission contains a more detailed elaboration of our reasons.
23. Finally, as requested by the Commission,<sup>5</sup> we are confining our comments for the most part to problem definition, rather than solutions. The corollary is that we understand that the Commission will outline a process for engaging in solution construction prior to the publication of its draft decision.

## 3. Key themes

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24. A number of key themes have emerged from the discussions so far, which underpin Powerco's submissions on the various specific topics, and are set out here in summary:
  - 24.1 **A clear articulation of what risks the WACC does and does not compensate for:** the Commission should clearly explain the risks an EDB is compensated for by the WACC. This has three elements.
    - (a) The Commission would help to focus the debate by acknowledging at the outset that the IMs review is not intended as an opportunity to re-litigate the fundamentals of the WACC methodology. The basic model has been the subject of extensive argument between stakeholders and experts, and there is little to be gained by re-opening consideration of these fundamental regulatory choices.
    - (b) The Commission should recognise that adjustments in the regulatory framework do not necessarily affect systematic risk, and therefore WACC. For example, as HoustonKemp have explained in their report, there is no reason to conclude that a change to the form of control from price to revenue control might affect the systematic risk faced by a regulated supplier, and therefore its asset beta. It would accordingly help to focus stakeholders' submissions on the core issues if the Commission confirmed at the outset that there will be no modification to the WACC parameters as a result of adjustments to the form of control.

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<sup>5</sup> Commerce Commission "*Input methodologies review: invitation to contribute to problem definition*" (16 June 2015) at [78].

- (c) Conversely, we note that some consumer groups have suggested that the implications of market and technology developments for the existing asset base mean that EDBs should be required to bear some risk of non-recovery of the RAB. This is not a risk that is currently compensated for by the WACC, and while we are of the view that the impact of market and technology development needs further consideration before any decision is made to change rules, we submit that any such change would require modifications to the WACC or to cashflows to compensate for this risk, were the Commission to pursue this line of reasoning.

**24.2 The importance of the regulatory compact on the RAB:** related to the point above, the Commission should bear in mind that the investment decisions of EDBs rely on their expectation that capex will be recovered through the RAB valuation. This is an important component of regulatory predictability and is a factor explicitly looked for by rating agencies. The reliability of the RAB valuation supports investment decisions, and thus is ultimately for the benefit of consumers. The importance of this regulatory compact should be acknowledged.

**24.3 Addressing volatility in externally observed WACC parameter values:** the Commission has identified, in relation to topic 3, that volatility in externally observed WACC parameter values has a substantial effect on regulated business' regulatory cost of capital. The Commission has framed this in the context of the interaction between the DPP and CPP, and the incentives that the different timing of WACC estimates creates for suppliers intending to apply for a CPP. We agree that this is an important issue and we have advocated for this issue to be resolved through the IM process. However, we also think the Commission should look at the wider issue of whether short term volatility in these parameters should be reflected in the WACC. In our view, it is inappropriate for a five-year WACC to be so disproportionately affected by short term changes in market conditions – for example, to interest rates. A WACC that is determined, and locked in for several years, based on spot observations of values that can fluctuate substantially in the short term is unlikely to be representative of the WACC that the business would actually experience over the course of the regulated period. Other regulators have recognised this, and have taken a number of steps to address short term volatility when estimating WACC. A number of options are available in international regulatory precedent, and the Commission should have regard to those precedents in this review.

**24.4 Understanding the cashflow implications of the IMs as a package:** it is important that the Commission bear in mind that there are real implications for regulated businesses' cashflows as a consequence of regulatory choices made in the context of IMs, and those cashflow implications have flow-on consequences for the financeability of the businesses. In addition to scrutinising the IMs for consistency with the Act and the Commission's regulatory objectives, the Commission should also consider the effect of the package of IMs as a whole on cashflow.

**24.5 Tariff structures:** Consideration needs to be given to reviewing the implications and overlap of the Commission's decisions, particularly in relation to the form of control and incentive mechanisms that may affect price allocation and options for future tariff reform.



## Detailed response to Commission's questions on specific topics

### 1. Risk allocation mechanisms under price-quality paths

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25. We consider that overall the current framework strikes a fair balance of risk allocation and, as such, is adequate. The framework needs longer to bed down and, consequently, we do not see any immediate need to broadly re-open the allocation of risk.
26. While that is our overarching view, we think there are three discrete issues in relation to risk allocation that warrant consideration in this IMs review:
- 26.1 The Commission has recognised that assessing the allocation of risk requires an examination of the IMs as a whole. Accordingly, were the Commission – in the pursuit of one of the other topics in its problem definition paper – to implement a change that affected the present balance, it would be necessary to assess the effect of that change on the overall allocation of risk between suppliers and consumers.
- 26.2 HoustonKemp explains in its report that the current approach to RAB indexation implicitly pushes out the depreciation profile and so delays the recovery of invested capital, which in turn may increase the cost of capital for businesses undertaking major investment projects, or reduce the incentive to invest. HoustonKemp proposes that the Commission consider allowing greater flexibility in the depreciation profile under the DPP and within the information disclosure requirements. We support further consideration of this issue.
- 26.3 The Commission should examine the various cashflow and real revenue implications of the ways in which the Commission's CPI forecasts are effectively incorporated into the DPP and CPP price paths, including via asset revaluations, as these processes can create real business risks.

### 2. The form of price control for price-quality regulated sectors

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27. The Commission has sought feedback on suggestions that the form of control for price-quality regulated sectors should be reassessed as part of the review. In particular, the Commission is interested in whether a move to revenue control, or a form of control that incorporates revenue control aspects, might be appropriate.
28. Powerco agrees that the merits of the current form of control and alternatives such as revenue control should be considered as part of this review. There is real benefit to reviewing the limitations of (and possible improvements to) both models. Wellington Electricity observed at the IM Forum that a variety of hybrid models might also be possible.
29. The Commission's problem definition paper and presentations at the IM Forum usefully examined some of the pros and cons of the various forms of control, including:<sup>6</sup>
- 29.1 the difficulty associated with forecasting energy volumes in the case of price control, which results in either under-recovery by suppliers or over-recovery from consumers in most regulatory periods;

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<sup>6</sup> Commerce Commission "*Input methodologies review: Invitation to contribute to problem definition*" (16 June 2015); Wellington Electricity Lines Limited "*Form of control*" (29 July 2015) at p 4.

- 29.2 the possibility that revenue control better incentivises energy efficiency and demand side management;
- 29.3 the possibility of price instability in the case of revenue control, if unders and overs are passed through in an unmanaged way.
30. HoustonKemp, in its report, also discusses the pros and cons of the various alternatives. HoustonKemp particularly emphasises that the specific details of the chosen implementation will be very influential in determining the final outcome.
31. Powerco considers there is a reasonable basis to conclude that a change in the form of regulation may provide tangible long-term benefits to consumers. Equally, WAPC should not be dismissed at the outset, but should be objectively compared against alternative forms of control. Accordingly, we support the Commission facilitating a balanced and objective discussion of the pros and cons of the various options. Like HoustonKemp, we think it is important that the Commission bear in mind that the specifics of the implementation will be critical to achieving any advantages of moving from price to revenue control.
32. The IM forum also examined the trend in international jurisdictions to move from price control of regulated industries to a revenue cap model. Powerco agrees that the experiences of these jurisdictions are relevant to the enquiry. That is not to say that New Zealand should adopt international precedent for the sake of it, but the experiences of those jurisdictions and the reasoning behind the shift in policy should be examined carefully against New Zealand conditions. The experiences of those jurisdictions following the shift to revenue control are also of interest.
33. Finally, we and HoustonKemp think it is important at the outset that the Commission acknowledge that a change from WAPC to revenue control has no relevance to the systematic risk faced by the regulated business, and therefore does not warrant any adjustment to the asset beta. We do not believe there is any evidence to support the view that the model of price control adopted by the Commission might affect WACC parameters or outcomes. Consequently, we do not consider that the impact of the form of control on WACC is a useful topic for discussion in the review.

### **3. Interactions between the DPP and CPP**

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#### **Summary**

34. Powerco supports consideration of two substantial issues in the context of CPPs:
- 34.1 As we have previously submitted, a single WACC should be applied to both the DPP and CPP price paths. This would serve to better align the incentives of suppliers with the stated legislative purpose of the CPP regime and focus supplier decision-making on the investment / performance needs case rather than on the implications of movements in interest rates and other externally observed WACC parameter values. We support the Commission's decision to address this issue in the context of the fast-track review process. We also acknowledge the concerns expressed by some stakeholders (e.g. MEUG) and their preference for the issue to be considered in the context of the full IM review process rather than the fast-track. Whilst that is obviously a matter for the Commission, if it becomes apparent that the Commission will be unable to adequately address this issue in the fast-track timetable, we would support transferring it to the full IM review.

34.2 The Commission should consider the advantages associated with permitting CPP applications that are limited to certain matters (e.g. 'single issue' CPP applications). Allowing a CPP application to proceed on the basis of a narrowly defined issue (e.g. demand forecasting) is likely to be in the long term interests of consumers.

35. We note that the Commission has decided to fast-track the first of those issues (WACC alignment), and has asked for submissions in relation to that issue by 21 August 2015. This submission responds to that invitation. We have already submitted extensively on this issue at earlier points in the process (see Powerco's submissions of 23 June 2015 and 10 July 2015). This submission incorporates and builds on those submissions.

### **DPP/ CPP WACC alignment**

36. As the Commission has noted in its problem definition paper, changes in WACC parameter values (for example the risk free rate) since the start of the DPP regulatory period mean that the DPP WACC may differ materially from the CPP WACC. That variance CPP may significantly affect the supplier's incentives to apply for a CPP.

37. We agree. This misalignment of the DPP WACC and CPP WACC results in a corresponding misalignment of the supplier's and consumers' long term interests, contrary to the purpose of the CPP process:

37.1 if the CPP WACC is lower than the DPP WACC, then suppliers may be deterred from applying for a CPP even where it is in the long term interests of consumers to customise the supplier's expenditure assumptions and/or quality standards; or

37.2 if the CPP WACC is higher than the DPP WACC, then suppliers have an incentive to apply for a CPP in order to capture that enhanced return on capital, even where the expenditure assumptions and quality standards in the DPP remain appropriate for that supplier.

38. The Commission has suggested several options for addressing this issue:

38.1 indexing prices to changes in the cost of debt (paragraph 197 of the problem definition paper);

38.2 substituting a long-run average risk-free rate (with or without annual updating) for the current spot rate observation (paragraph 198);

38.3 WACC alignment: carrying over the prevailing DPP WACC into the CPP (paragraph 200). When the DPP WACC changes, it would change for the CPP also.

39. As we have explained in our earlier submissions, only the third of these options constitutes an immediate solution to the problem of how to appropriately align incentives for the 2016 CPP application windows. The first and second options only narrow – rather than eliminate – the variance between the DPP and CPP WACCs, and would only take effect at the point of the next DPP determination in 2020.<sup>7</sup>

40. The Commission has acknowledged this point and elected to address WACC alignment in the context of the fast-track process. We support that decision, and reiterate our view

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<sup>7</sup> These alternative proposals should, however, also be considered in the context of the full IMs review, as they may have merit independent of the more immediate problem of aligning the DPP and CPP WACCs: see paragraph 74 infra.

that the current misalignment is a significant concern that can be best addressed by carrying over the DPP WACC into the CPP.

41. Our submission of 23 June 2015 explained in detail how the alignment of DPP and CPP WACCs would be achieved, relying on input from Jeff Balchin of Incenta Consulting: see paragraphs 33 to 40 of that submission. Mr Balchin is available to assist the Commission further in the development of this solution.
42. An additional point that the Commission should consider is the approach used for calculating the revaluation rate and inflation rate in the context of the CPP. The DPP IM uses actual CPI values to revalue the RAB, whereas the CPP IM uses a blend of the most recent reported quarterly CPI and the most recent Reserve Bank forecasts. The Commission should consider whether it is appropriate to take a consistent approach in relation to both the DPP and CPP.
43. We acknowledge MEUG's concern that the issue of WACC alignment may be unsuitable for fast-track determination to the extent it has implications for other topics that are the subject of the full IMs review. We remain of the view that our proposal to carry over the DPP WACC into the CPP is a discrete issue that can be considered in isolation.
44. However, even if the Commission considered MEUG's concern to be well-founded, we do not think that would be a reason to take this proposal out of the fast-track process. MEUG will have an opportunity in the course of the fast-track to explain why they do not think the Commission can reach a final decision on this proposal without considering other issues that are not within the scope of the fast-track review. The Commission may in due course find that it agrees with MEUG. In that case, nothing would prevent the Commission from holding over its final determination on this issue until it had a chance to consider the wider implications in the context of the full IM review. The Commission would not have wasted or duplicated any effort or resource by including this proposal in the fast-track process. We are alive to the possibility that it may turn out to be impossible to resolve this question in the context of the fast-track review, and have considered the impact it might have on our planning for our CPP application.

#### *Revising the methodology for estimating cost of debt*

45. Putting aside the immediate problem of the misalignment of the DPP and CPP WACCs, the two alternatives proposed by the Commission (paragraphs 197 and 198) may independently have merit, and should be considered in the context of the general IM review. In our view, the Commission should particularly focus on substituting a long-run average, or trailing average, when estimating the risk-free rate rather than the current one-month prevailing estimate. As HoustonKemp explains in its report (see also in relation to topic 5 below) adopting a trailing average estimate of the cost of debt would:
  - 45.1 improve the incentives on businesses to make efficient and prudent financing decisions; and
  - 45.2 reduce unnecessary volatility in regulated prices.

#### **Single issue CPP applications**

46. We support the Commission's decision to consider changing the IMs to allow for CPP applications to be limited to certain matters. In our view, permitting single issue applications will result in more efficient utilisation of the Commission's resources, and also mitigate the chilling effect that the cost and complexity of the full process can have on a supplier's decision to take a CPP application forward.

## 4. The future impact of emerging technologies in the energy sector

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47. The Commission has sought viewpoints and feedback concerning how and when emerging technologies will impact the energy market, and how the Commission should respond to the issues that this next generation of technology poses for regulated businesses.
48. Again, we think the IM forum provided a useful opportunity for the expression of viewpoints and ideas on this topic. Overall, Powerco supports the views raised by the Smart Grid Forum at the IM Forum and in its early submission as well as the views put forward by Orion at the IM Forum. In particular, while emerging technologies have real potential to change the way the industry operates, we agree that views on this topic remain, for the most part, speculative.
49. While we can make some high level assumptions about the role of these technologies in the market and their effects on consumer behaviour, it is not yet appropriate to factor their possible (but speculative) risks and benefits into the input methodologies:
- 49.1 The new generation of technologies is not yet here at scale and adequate economic payback and there is no certainty that technology change will be a significant feature of the market during the next regulatory period. While we are able to observe advances in technology, such as improvements in the efficiency of solar panels and the cost of batteries, and there is little doubt that over the life of current network assets these technologies will result in changes to the ways network companies will operate and manage their assets, it is not possible to predict with confidence the pace or scale of change and what changes to the IMs may be required at some later date;
- 49.2 Technology uptake is difficult to predict. Many price sensitive consumers will elect not to take up new technologies until the upfront cost is comparatively low and/or the economic benefits are substantial. It is not certain when the cost of emerging technologies will become economically viable for everyday consumers;
- 49.3 As the representatives of the Smart Grid Forum explained at the IMs forum, the way that emerging technologies will affect future demand patterns is also unclear. There are credible scenarios that support both increased and decreased use. Demand patterns are generally influenced by a number of factors, including rate setting. Rate setting will inevitably be responsive to the behaviours that the new technologies facilitate and incentivise, and will require significant overhaul;
- 49.4 These combined factors make it difficult to predict what risk of asset stranding regulated businesses actually face. However, it is possible that future network architecture will lead to some stranding of assets, while at the same time requiring network investment in order to accommodate new technologies.
50. We believe that these questions cannot be answered before the advent of the next regulatory period, and consequently the Commission cannot be confident that it will be able to reach a well-supported and robust decision in relation to these issues in the course of this review. We therefore support the view of the Smart Grid Forum that an abstract and uninformed response to the issues posed by the next generation of technology is not helpful. We should use the opportunity presented during the next regulatory period to become better informed about where technologies are headed, and the impact of those technologies on network architecture and demand.

51. We support investigating the issues related to emerging technologies over the next couple of years in a systematic and collaborative way. This approach is more likely to lead ultimately to sensible, rather than speculative, regulation.

## **5. Issues raised by the High Court on cost of capital**

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52. Enclosed with this submission and forming part of it is a report prepared by HoustonKemp that responds to the issues raised by the Commission in relation to this topic. In summary, HoustonKemp's view – supported by Powerco – is that there are several fundamental aspects of the WACC methodology in relation to which further debate at this point is unlikely to identify opportunities for improvement, namely:
- 52.1 the reliance on the simplified Brennan Lally capital asset pricing model (SBL-CAPM);
  - 52.2 the WACC percentile for electricity lines and gas pipelines businesses;
  - 52.3 the introduction of a split-WACC approach; and
  - 52.4 amending the asset betas on the basis of the form of control.
53. The current position in relation to those issues reflects a reasonable settlement that has been arrived at after lengthy consultation and, indeed, litigation. We do not believe that circumstances have changed such that these issues should be re-opened, or that new information or reasons to explore these proposals are likely to emerge in the course of the review.
54. The Commission has also set out in its problem definition paper persuasive reasons not to take any further MEUG's proposal for a split cost of capital, or to re-examine the WACC percentile. As the Commission notes, it has not previously favoured a split cost of capital due to its potential to distort investment, increase the risk of underinvestment, and increase the administrative burden. We agree. Instead, the Commission reviewed the WACC percentile, addressing many of the same issues that would otherwise be addressed by a split WACC. Given how recently that review was completed, it would not be appropriate to re-open the WACC percentile, and equally therefore not appropriate to explore a split WACC as an alternative way to explore the balance between investment incentives and costs to consumers.
55. However, as HoustonKemp explains, there is value in reconsidering the methodology that the Commission uses to estimate the cost of debt. The current approach of adopting a five year term for the cost of debt, and estimating the risk-free rate based on a one-month (prevailing) average, assumes that regulated businesses would issue debt for a relatively short period of time, and in a single tranche at the outset of the regulatory period. In fact, a prudent and efficient business would issue longer term debt, and would issue debt in several tranches in order to reduce its exposure to short term changes in interest rates. The current approach also means that the cost of debt, and consequently prices, are unduly influenced by short term changes in market conditions. We note that the Commission has already acknowledged (in relation to the interaction between the DPP and CPP) that volatility in externally observed WACC parameter values can substantially affect the WACC estimate, and the timing of the regulatory decision-making process therefore has a disproportionate influence on the WACC for the regulatory period.
56. In response to these concerns, the Commission has already proposed alternative methodologies for estimating the cost of debt in paragraphs 197 and 198 of its problem

definition paper. We support further consideration of these issues, and particularly HoustonKemp's proposals to:

- 56.1 adopt a ten-year rather than five-year term for the cost of debt; and
  - 56.2 adopt a trailing average methodology that involves annual updating of the WACC on the basis of a rolling average of the cost of debt (rather than a one-month average estimate observed at the outset of the regulatory period).
57. Adopting these measures would ensure that the WACC estimate is less influenced by short term changes in market conditions, and would also align the cost of debt methodology with the debt-management strategies that would be expected of an efficient and prudent business. It would therefore:
- 57.1 improve the incentives on businesses to make efficient and prudent financing decisions; and
  - 57.2 reduce unnecessary volatility in regulated prices.

### **Uncompensated debt costs**

58. In addition to the proposals, there are a number of costs associated with raising debt that are currently not compensated by the IMs:
- 58.1 **Cost of 'headroom'**: all businesses, irrespective of size or complexity must have access to undrawn debt facilities to enable them to respond to unbudgeted, unforeseen or unusual costs. Standard & Poor's expectation is that a company like Powerco should have sufficient headroom – in the form of undrawn debt facilities and free cash earnings – to enable it to fund the next 12 months of budgeted capex and debt repayment obligations.
  - 58.2 Businesses typically operate their headroom via undrawn bank debt facilities, meaning they pay fees to their banks to have access to additional but undrawn funds. A typical fee would be around 60-80 basis points. This is a significant component of the cost of debt that is not currently compensated by the IMs.
  - 58.3 **Cost of carry**: businesses can rarely raise new debt on the day that an existing debt facility matures. This means they incur a cost associated with carrying two debt facilities simultaneously for the period of the overlap. When an EDB raises a new bank facility to pay a maturing facility there is the option to cancel the maturing facility early; however this is not costless. Upon early repayment, the EDB will be required to pay whatever portion of the establishment fee (which is typically amortised over the term of the facility) that remains outstanding. Accordingly, there is still some duplicated cost associated with early termination.
  - 58.4 Where an EDB raises debt capital through a bond issue, there is no flexibility to repay early, and therefore the cost of carry is unavoidable.
  - 58.5 This issue is exacerbated by Standard & Poor's refinancing guidelines, which, for a BBB+ rated entity, require the refinancing of debt to be completed 3-6 months ahead of maturing debt. To illustrate this issue, assume a bond issued at 5%, used to repay a maturing 5% bond, issued three months ahead of maturity. The cost of carry associated with the overlap between the two bonds would be \$125,000 per \$10 million of debt. This cost is currently not compensated by the IMs.

58.6 **Cost of hedging:** the Commission's regulatory framework encourage a prudent EDB to enter into hedging arrangements to align its interest rate exposure to the rate included in the Commission's estimate for the cost of debt.<sup>8</sup> Hedging carries a cost – typically around 10 basis points charged on the amount of debt that is hedged, equating to a cost of \$10,000 per \$10 million of debt hedged. This is also an uncompensated cost.

59. The Commission should consider introducing a mechanism to reflect these debt-raising costs, in conjunction with re-examining its methodology for estimating the cost of debt.

## **8. Cost-effectiveness of the rules and processes for CPP applications**

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### **Key points for the review**

60. The Commission has sought feedback on suggestions that the cost-effectiveness of the rules and processes for CPP applications should be reassessed as part of the review. In particular, the Commission is interested in how the rules and processes for making a CPP application might be improved in order to reduce complexity and make the CPP process more cost-effective.

61. It was clearly identified through the responses to the Commission's 2014 request for feedback on setting Orion's customised price-quality path that the current CPP application rules and process are overly complex and subsequently costly.

62. The result of the current CPP IM rules and processes is that an appropriate balance between cost effectiveness and having sufficient information available to the Commission to determine a CPP is not being struck. The consequence of this is that barriers exist to considering a CPP as a viable alternative to a DPP.

63. As previously stated in our submissions to the setting of Orion's customised price-quality path and the scope and process for fast track amendments to the CPP input methodology requirements, we consider the main causes of excessive cost and complexity to be:

63.1 the prescriptiveness of the application requirements;

63.2 the role and scope of verification (verifier and engineer), consultation and audit processes; and

63.3 lack of alignment of information with suppliers existing practices.

64. As identified in the problem definition paper, many of the issues identified in this topic relate to striking an appropriate balance between cost-effectiveness and having sufficient information available to the Commission to determine a CPP under s.53V. When considering the issue of information requirements we believe it is important to recognise that the Commission can always request further information from a supplier, if necessary, after the proposal has been submitted – see s.53S(2)(b) and s.53ZD. As such, the hard coded information requirements should be drafted to reflect this.

65. The main issues that would reduce the complexity of the requirements and break down barriers to applying for a CPP have been identified via the Commission's Orion determination process and initial consultations on the 2017 IM Review. The correct issues have been identified during past consultations and summarised by the

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<sup>8</sup> See: Powerco "*Scope and process for fast track amendments to the CPP input methodology requirements*" (23 June 2015) at [11].



Commission in its current problem definition consultation paper. As such we do not have any new issues to add and consider that the focus needs to be on designing the amendments to remedy the identified issues.

### Response to Commission’s invitations to make submission

66. The following table provides our direct responses to the questions raised in paragraph 453 of the Commission’s problem definition paper.

Ref	Commission Question	Powerco Response
453.1	Feedback on the Orion process published on our web site. In particular, whether:	
453.1.1	This feedback remains relevant / the identified areas are still priorities for future work;	Yes. The five key areas of verification, customer consultation, information requirements, CPP following a catastrophic event, time and cost require attention as per the Orion process review findings.
453.1.2	There are any additional matters you wish to raise in respect of either the CPP application process or the CPP technical issues;	No. The issues have all been correctly identified in para. 418 of the paper. There is significant work required on each of the seven main issues that need further fleshing out and this would be best progressed via industry workshops.
453.2	Any other experience you feel would be relevant in addressing these or any other issues relevant to this topic;	Powerco’s experience to date of considering and preparing for a CPP in “business as usual” circumstances has aided our understanding of the detail of the processes and rules. We are available to meet with the Commission during the solution development stage to share our learnings.
453.3	The problem definitions within this topic area;	We agree with the two problem definitions presented. However, the disincentive to apply for a CPP due to the costs involved has not been as clearly defined in the problem definition as it is in the introduction to the topic in section 7 of the paper.
453.4	Potential solutions to the specific problems identified. Submissions on solutions need only be at a high level at this stage, expressed in terms of how they promote the long-term benefit of consumers. However, where specific solutions are identified, we welcome more detailed submissions on those, especially where they relate to issues you consider should be fast-tracked.	Proposed improvements have been well documented through feedback to the setting of Orion’s CPP (April 2014) and earlier rounds of the IM Review process <sup>9,10</sup> . Comments on Limb 1 of the fast track process are detailed below.

<sup>9</sup> Commerce Commission “*Consultation: Proposed Scope, Timing and focus for the review of input methodologies – Open letter*” (27 February 2015).

<sup>10</sup> Commerce Commission “*Consultation on Fast Track: Intention to commence a review of Input Methodologies*” (10 June 2015).

## **IM fast track process**

67. Powerco continues to support the process of using a fast track mechanism to address CPP process and rule requirements that can be usefully completed ahead of the main review and are specific and separable from the main IM Review.
68. In our submission on the scope and process for fast track amendments to the CPP input methodology requirements submitted on 23 June 2015, we identified areas we considered high priority. These were:
  - 68.1 information no longer aligned with other aspects of the framework;
  - 68.2 information inconstantly defined;
  - 68.3 necessity of information; and
  - 68.4 role and scope of the verifier.
69. We consider that these areas of priority are still applicable and should form the focus of the CPP fast track amendments review. Our 23 June 2015 submission on the subject sets out key areas to be addressed and we would welcome the opportunity to support any future drafting via engagement with the Commission.
70. We agree with the Commission that a line by line review of the CPP IMs is not possible or required as part of the fast track process. We do, however, consider that as part of the main IM Review a full review of the IMs should be undertaken and the starting point should be the issues that have been identified in past submissions.

## **Other Issues**

### *Single issue CPP*

71. The CPP process, as currently conceived, is disproportionately costly in circumstances where suppliers require a departure from the DPP that is limited to a single, discrete and clearly defined issue. The Commission should consider amending the DPP or CPP IMs to allow for single-issue departures from DPPs.

### *Effect of IM amendments made during the evaluation of a CPP*

72. Certainty is an essential part of the consideration process for applying for a CPP. As such, we agree with the Commissions view that the IMs that were in force at the time the application was made should be the ones that apply.
73. The opportunity for the Commission and the potential CPP applicant to have the flexibility to discuss and agree the IMs that apply is an important and value adding exercise. As such, we consider that this discussion and agreement should form part of a formal “pre-submission” process.

## **Recommendations**

74. In summary, we recommend the following;
  - 74.1 A working group should be established to refine the scope of, and test, proposed amendments.

- 74.2 A flexible approach should be adopted that can be tailored to EDB circumstances. This would help reduce costs and improve overall outcomes.
- 74.3 Introduction of a “pre-submission” process to allow the tailoring of certain requirements to a specific application.
- 74.4 There should be a greater focus on guidance rather than “one size fits all” requirements. This would help recognise the scale differences that exist amongst EDBs.
- 74.5 Remove information requirements that are no longer aligned with other aspects of the framework.
- 74.6 Clarify and simplify core information requirements.
- 74.7 A full review of the IMs outside the fast track process.

## **9. Reducing complexity and compliance costs**

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- 75. The industry’s understanding of the IMs has improved as they have been applied and the additional guidance now available helps counter the unavoidable complexity of the IMs. However, while we do not consider any significant changes are needed, incremental improvement is still required to reduce the ambiguity, compliance costs and unintended consequences that remain a barrier to their efficient use.
- 76. We have reviewed and support the Electricity Networks Associations comments on matters related to reducing complexity and compliance costs.
- 77. Powerco has developed systems and processes to deal with the complexity of the IMs and IM variations from standard practices such as GAAP. As a result we are of the view that no significant changes should be made to the IMs unless a clear case for reducing cost and complexity for all parties can be demonstrated.
- 78. We consider it is essential that provision be made during the IM review process, and through the decision making framework, for drafting errors, ambiguity and business as usual improvements to be addressed. These would be best addressed through technical working groups reviewing areas and providing the Commission with guidance.
- 79. One area that we strongly believe is adding additional complexity to the framework is the Incremental Rolling Incentive Scheme (IRIS). Outstanding elements of the mechanism still need to be resolved (e.g. the process for moving from a CPP to a DPP) as the incentive has become complicated and its meaningfulness is now questionable.
- 80. The current process for undertaking the a full review of the IMs should not only focus on those matters considered complex and costly but also those that improve the purpose and operation of the IMs and the wider regulatory framework. One example the Commission needs to consider is the follow up to the Information Disclosure amendment review that identified IMs that caused the deferral of matters that would have materially improved the information disclosures. At the time, the Commissions reason paper<sup>11</sup> stated that these IM constraints would be addressed as part of this IM review.

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<sup>11</sup> Commerce Commission “*Amendments to information disclosure determinations for electricity distribution and gas pipeline services: Final reasons paper*” (24 March 2015) at page 58.

## 10. Process from here

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81. In our submission of 10 July 2015 regarding the proposed fast-tracking of the interaction between the DPP and CPP, we suggested that there was a need for intermediate steps between the problem definition phase and the draft decision, which is currently scheduled for mid-Q2 2016. We proposed that those intermediate steps might involve:
- 81.1 a follow-up to the invitation paper that would summarise any developing consensus from the forum, to narrow the scope of the exercise to those issues, and potential solutions, which remain in serious contemplation; and/or
  - 81.2 an iterative process of releasing discussion papers in the solution construction phase to enable engagement on possible solutions prior to the release of the draft decision.
82. The Commission indicated on 23 July 2015 that it anticipated “a further opportunity for engagement and comment by stakeholders” prior to the release of the draft decision.
83. We support a process that allows for structured engagement with the Commission’s developing thinking between now and the publication of the draft decision. This is particularly important given the Commission’s request that we limit our submissions at this stage to problem definition, rather than proposing solutions.
84. Given the constructive and collaborative nature of the Commission’s process so far, we think the Commission’s decision-making can only benefit from further engagement in the solution construction phase. In our view, such a process should be:
- 84.1 driven by the issues, and the development of the Commission’s thinking, rather than an unduly formalistic process that would apply rigidly across all topics;
  - 84.2 flexible enough to accommodate different modes of engagement, depending on what is most likely to produce useful inputs; for example, workshops, draft position papers and, opportunities to make submissions on discrete issues;
  - 84.3 iterative, if necessary, to permit constructive feedback between the Commission and stakeholders on proposed solutions and their implications.
85. While we think it is unnecessary for the Commission to announce an exhaustive formal timetable for its engagement plan during the solution construction phase, we think the Commission should state the principles that would govern how it proposes to approach engagement, as well as some key milestones for the engagement timetable.
86. If you wish to discuss this submission please contact Richard Fletcher, at [richard.fletcher@powerco.co.nz](mailto:richard.fletcher@powerco.co.nz). or on (04)978 9910, in the first instance.

Yours sincerely



Richard Fletcher  
General Manager Regulation and Government Affairs