



# IM FORUM – DPP / CPP WACC Alignment

30 July 2015

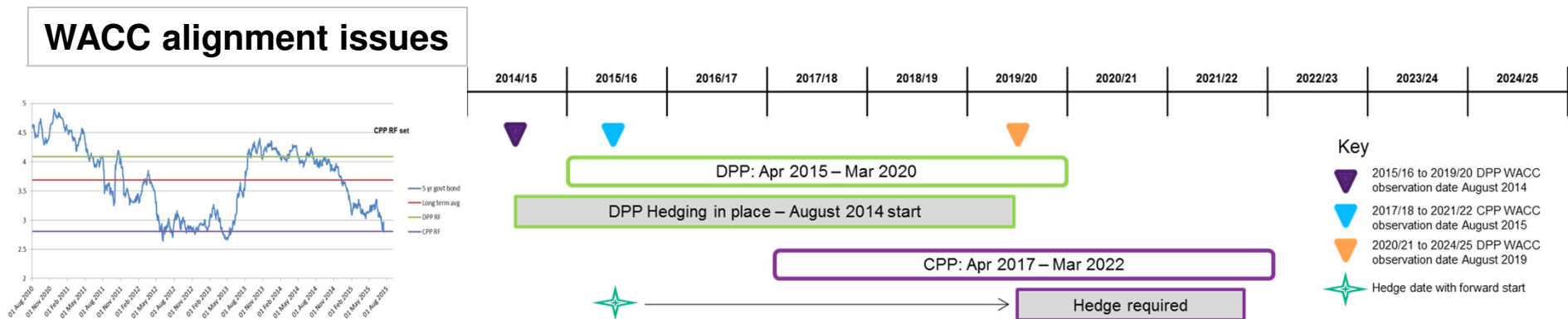
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## To recap on the problem...

- CPP IM requires a new WACC to be specified for a CPP based on updated observations of the cost of debt parameters (interest rate).
- Depending on the volatility of interest rates (RFR) this can create a big divergence (+ve or -ve) between the prevailing DPP WACC and the new CPP WACC
- The problem creates a real **perverse incentive** to base a CPP timing decision on the prevailing interest rate – not in the long term interests of consumers.
- Aligning the DPP and CPP WACCs (ie. adoption of a single regulatory WACC for any five year RCP whether on DPP or CPP) is a principled solution - from both a consumer and supplier point of view – makes a supplier / customer neutral to interest rate movements.
- Powerco supports the Commission's recent decision to fast track its decision to align the WACCs in order to keep a 2016 CPP application viable – we believe such a decision is severable from the wider IM review.
- Aligning the WACCs via the fast track process does not preclude further consideration – via the full IM review - of how the WACC is set.

# The problem is real in Powerco's case

- Powerco is planning a CPP application for 2016 (start 1 April 2017) – refer AMP
- Difference in RFR DPP to CPP circa **100 basis points** – material dollar impact
- Downside financial implications are compounded due to associated hedge costs (expected mechanism within the regime to manage interest rate risk)
- CPP application in 2016 not considered viable unless the issue is addressed



# The proposed solution in summary

- The WACC for a CPP would align with the prevailing DPP WACC
- When the DPP WACC changes the CPP WACC changes also
- Straightforward amendment to CPP IM – can be fast tracked as separate item
- Misalignment issue can be addressed separately from the wider IM Review (including any substantive review of the WACC IM)

Proposed solution	Comment
Carrying over the prevailing DPP WACC into the CPP	<ul style="list-style-type: none"><li>• Requires a change to the <u>CPP</u> IMs only</li><li>• Eliminates the misalignment between the DPP and CPP WACCs</li><li>• Addresses the immediate problem – facilitates CPP applications in 2016</li></ul>

# Considerations for the IM Review

**Is there general consensus that the problem has been appropriately defined?**

**Is there general consensus that the proposed solution would address the problem?**

**The questions then are:**

- Is the principle of aligning the WACC severable from a review of how WACC is set?
- Are there any other solutions that can better address the perverse CPP timing incentive?
- Is an aligned WACC solution implementable within the current IM framework?
- Does the “CPP Fast Track” allow sufficient time to make an enduring decision?

# Powerco's position

- May 2016 is the CPP submission date we have signalled and we have been actively preparing since 2014
- We acknowledge the Commission's decision to fast track DPP / CPP WACC alignment with a final decision targeted for February 2016
- However, a May 2016 submission requires that we commit to engaging a verifier and accelerating our final preparations in the next few months (some time prior to the February decision)
- While we are willing to proceed without full certainty on the final outcome we are today seeking some positive signals / certainty that there is a commitment (across stakeholders) to resolve this issue within the fast track timeframe.
- Pragmatically though, if the issue is likely to be complicated or the process protracted then we suggest reverting the issue to the full IM programme – albeit this is considered to be a suboptimal outcome. In such a case we would most likely defer our CPP by at least one year



# IM FORUM – DPP / CPP WACC Alignment Proposed Implementation

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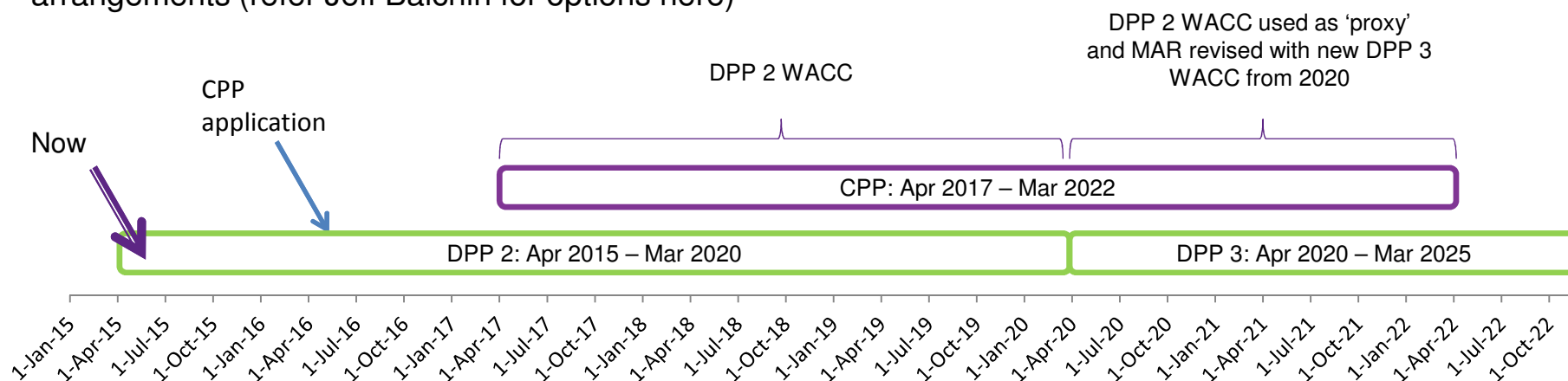
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# How it would work - carrying over the DPP WACC to a CPP

## Two steps for carrying over the DPP WACC into the CPP:

1. Apply the DPP 2 WACC to the CPP.
  - use the DPP 2 WACC as a 'proxy' for DPP 3 (i.e. assume that DPP 3 WACC would be the same as DPP 2)
2. Revise the CPP MAR from the first year of DPP 3
  - (i.e. 2020) to apply the new DPP 3 WACC to the remainder of the CPP term. This unwinds the error from using a 'proxy' value at the outset

It would also be appropriate to carry through the associated inflation forecast into the CPP in order to leave intact the natural hedge for inflation that the Commission has observed is present in the current arrangements (refer Jeff Balchin for options here)





# Implementation is via amendment to CPP IM only

## Jeff Balchin's analysis - Proposed amendments to CPP IMs

- Insert reference to the objective of the MAR revision calculation, which would be to:

*derive the MAR for the remaining years of the CPP period that would have been calculated when determining the CPP if the DPP WACC (and inflation forecasts) for the full term of the CPP had been known at that time, holding fixed all forecasts except the WACC (and inflation forecasts) and holding fixed the MAR determined for the period prior to the revision of the CPP*

- Amend the definition of cost of capital in clause 5.3.2 to refer to the cost of capital applicable for the corresponding DPP period, or a reasonable proxy for that value (i.e. for the period where the CPP will extend past the current DPP period)
- Change the definition of “forecast CPI as it applies to Part 5 to refer to the use of values for inflation that are consistent with the forecasts of inflation that were adopted in the DPP
- Amend clause 5.3.6 to allow for a step change in the MAR at the changeover between one DPP and the next
- Insert a new clause to enable the MAR to be revised at the changeover between one DPP and the next to adjust for the difference between the proxy for the WACC (and inflation forecasts) that was adopted in the original calculation of the MAR and the WACC (and forecasts of inflation) that apply for the new DPP period

## No changes required in the DPP IMs

Powerco proposes a workshop facilitated by Jeff Balchin to work through the implementation methodology in the early stages of the fast track programme

# Implementation in the financial model

The financial model used to determine the initial MAR at the outset of the CPP would be re-run for the period of the CPP that overlaps with DPP 3, with the new WACC and inflation forecasts inserted into the model. In detail:

- At the outset of the CPP, a MAR for the full period is determined based upon current DPP 2 WACC and inflation, including using DPP 2 WACC and inflation as a proxy for the period of the CPP that will overlap with DPP 3
- The model would include the capacity for a change to the MAR from the first year of DPP 3, but that change would initially be set to zero. The model would also allow the specification of different WACCs across the CPP period, but with a proxy used initially for the period of the CPP that overlaps with DPP 3
- The model would determine the full interrelationship between the inflation forecast and the price. The inflation forecast would feed into the forecast of RAB revaluations as well as the forecast escalation in the MAR in order to preserve the 'natural hedge'
- Once the DPP WACC and inflation forecasts for DPP 3 are determined, these would be inserted into the model and the MAR adjustment referred to above would be determined. All forecasts apart from WACC and inflation would remain unchanged, and the MAR for the period of the CPP that overlaps with DPP 2 would also be held fixed at the initially determined values