HORIZON ENERGY

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Brett Woods
Senior Analyst
Regulation Branch
Commerce Commission

By email: regulation.branch@comcom.govt.nz

Dear Mr Woods

Submission on the invitation to provide feedback on whether the Commerce Commission should review or amend the cost of capital input methodologies

1. Introduction

1. Horizon Energy Distribution Limited ("Horizon Energy") welcomes the opportunity to provide feedback to the Commerce Commission ("Commission") on the invitation to provide feedback on whether the Commerce Commission should review or amend the cost of capital input methodologies ("cost of capital paper").

2. We support the submission provided by the Electricity Networks Association ("ENA").

3. We understand the Commission is seeking views on how to address the uncertainty created within the December 2013 High Court judgement on the merits appeals of the input methodologies ("IMs") that were set in December 2010.

4. We understand the High Court questioned whether empirical evidence and theoretical results justify the Commission's use of the 75th percentile estimate of the weighted average cost of capital ("WACC") to set price-quality paths, and implied that use may be at odds with the s52A(1)(d) of the Commerce Act 1986 ("the Act") objective in terms of limiting the ability of regulated suppliers to earn excessive profits.

5. We understand that a number of consumer groups have requested that the Commission urgently review the cost of capital IMs so that the revised IMs could be applied in the November 2014 reset of the Default Price-Quality Path ("DPP") for Electricity Distribution Businesses ("EDB's").

2. Review of the Cost of Capital Input Methodologies

6. We question the value of revisiting the cost of capital IMs earlier than January 2018 as this will add additional uncertainty for non-exempt EDBs for the November 2014 reset, given that there already is significant uncertainty surrounding the November 2014 reset.

7. We agree with the Commission that given the range of issues a review of the cost of capital IMs would need to cover, it is very unlikely that the Commission could complete a review in time for any revised IMs to be applied in the November 2014 reset of the DPP for non-exempt EDBs.

8. We do not agree that uncertainty surrounding the retaining, reducing or removing the uplift from the mid-point to the 75th percentile will discourage the intended incentives for efficient investment, due to the timeframe for a January 2018 review of the cost of capital IMs being already well known.

3. Review of the 75th percentile only

9. We submit that given the considerable uncertainty that already surrounds the November 2014 reset of the DPP for non-exempt EDBs, any review of the cost of capital IMs solely to the use of the 75th percentile will only add to this uncertainty.

10. As part of the consultation process for the November 2012 reset of the DPP for non-exempt EDBs, suggestion was made to include a 'band' around the WACC to better meet the purpose of Part 4 as set out in s52A(1) of the Act.

11. The Commission dismissed the need for the 'band' around the WACC as signalled throughout the course of the consultation process for the November 2012 reset of the DPP for non-exempt EDBs. The use of the 75th percentile mitigates a number of risks including the estimation of the WACC itself, and the risks that non-exempt EDBs face within a top down 'one size fits all' approach to modelling EDB's current and projected profitability.

12. In addition to the 75th percentile WACC mitigating estimation and forecast risk, mitigation for catastrophe risks provides an ex-ante requirement for compensation within the WACC.

13. As a result of the Orion New Zealand Limited Customised Price-Quality Path Determination 2013, the Commission has stated within footnote 365 of the final reasons paper that -

    WACC provides compensation for the normal systematic demand risks. The only possible case for any additional compensation would relate to an asymmetry in demand risk that was introduced by the effect of catastrophes on demand, which was sufficiently large that it is not covered by the 75th percentile WACC estimate.

14. Clearly this statement suggests that the Commission is satisfied the 75th percentile WACC provides enough uplift to accommodate the asymmetric demand risk resulting from catastrophic events. Therefore in contemplating any reduction or removal of the uplift, EDB's will be exposed to asymmetric demand risk resulting from catastrophic events.

15. The 75th percentile WACC remains appropriate given the risks EDBs face and any reduction or removal of the uplift from the mid-point will limit the ability of EDBs to earn a normal return and be incentivised to innovate and invest.

16. A rushed review of the 75th percentile WACC and any subsequent reduction or removal would lead to a loss of confidence in the Part 4 regime by investors and funders.

17. We look forward to working with the Commission in any further consultation on revisiting the cost of capital IMs prior to January 2018.

18. Thank you for considering this submission. Please find contact details below to discuss any of these matters further.

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