

5/05/2014

Brett Woods
Senior Analyst
Commerce Commission
PO Box 2351
Wellington

(sent by email to Regulation.branch@comcom.govt.nz)

Dear Brett,

REPORT ON CHOICE OF WACC PERCENTILE

Dear Brett

Attached to this letter is a report from Andrew Shelley Economic Consulting ("ASEC") responding to a request from Unison to consider the selection of the WACC percentile in the context of risks faced by regulated EDBs. This is provided in response to the Commission's paper: *'Further work on the cost of capital input methodologies: Process update and invitation to provide evidence on the WACC percentile'* (31 March 2014) (Consultation Paper).

In the time available ASEC has identified that a number of issues need to be considered, which has implications not just for the setting of WACC percentile, but the broader suite of regulatory arrangements for EDBs in the context of:

1. Catastrophic event risks and how these are handled, especially given EDBs are unable to obtain cost-effective insurance of a large proportion of their assets and the associated revenues;
2. Market-based risks, such as volume/stranding issues arising from rising penetration of alternatives and relative price changes between the costs of delivered electricity and these alternatives; and
3. The regulatory cost-recovery approach (particularly indexation of the RAB and depreciation profiles), which require EDBs to recover substantial proportions of revenues from consumers a long-time in the future.

ASEC has also identified that the economic costs of setting a regulatory WACC too low are likely to be substantially higher than setting the regulatory WACC too high. Allocative efficiency costs of setting the regulatory WACC higher than the unobservable true WACC are minor and would be easily out-weighed by small decreases in reliability or cost-shifting to consumers, as EDBs seek to reduce discretionary investment if the WACC were too low.

In this context of market and regulatory risks and asymmetric consequences of error in setting the regulatory WACC, ASEC cautions that the Commission should be wary of departing from use of the 75th percentile, noting that the AER has recently determined to set individual parameters in its estimates of WACC at or near the top end of estimated ranges.

Unison agrees with the findings in ASEC's report. Unison holds significant concerns that we face significant asymmetry in risks that are not currently addressed by the IMs, as a result of potential for catastrophic events and medium-term stranding risks. We also have not seen any evidence to suggest that the regulatory WACC over-estimates the true cost of capital: indeed we understand CEG has undertaken analysis which shows that the regulatory WACC in New Zealand, even at the 75th percentile estimate, results in a significantly lower premium relative to Government bond rates compared to those exhibited in Australia, UK and the USA.

Unison remains firmly of the view that all these issues need to be considered in a holistic, systematic manner when the all the IMs are reviewed, and therefore we continue to encourage the Commission to discontinue the current, narrowly-focussed process to review the WACC percentile.

Kind regards

A handwritten signature in black ink, appearing to read 'Nathan Strong', with a stylized flourish at the end.

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE