
Submission

Input Methodologies Review: Frontier Economics' report on Lally ROTD Appendix

26 October 2016

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1 Introduction

Aurora welcomes the opportunity to submit in response to Frontier Economics' report, prepared for Transpower, *Issues arising from Commerce Commission WACC workshop, 4 October 2016* (the Frontier Report).

No part of our submission is confidential and we are happy for it to be publicly released.

If the Commission has any queries regarding this submission, please do not hesitate to contact Alec Findlater:

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2 The Lally Appendix

Aurora agrees with the analysis and conclusions the Frontier Report reached on Dr Lally's Appendix¹, including but not limited to:

- *"The key conclusion in the Lally appendix (i.e., that the rate on the day approach creates better incentives for efficient investment than does the trailing average approach) are due to the particular erroneous assumptions embedded within the analysis"*².
- Dr Lally's Appendix analysis excluded existing and sunk assets: *"the NPV=0 violation that arises under the rate on the day, in respect of all existing assets, can be very large"*³.
- Dr Lally's Appendix only consider the debt risk premium and excluded the risk free rate: *"the violations that occur in relation to the base risk-free rate can have a larger magnitude and this risk is minimised under the trailing average approach"*⁴.
- Once corrections are made to Dr Lally's analysis *"To the extent that the analysis of mismatches is relevant, it favours the trailing average approach"*⁵.

Our review of the Appendix also supports Frontier's view that the analysis contains "erroneous assumptions". For example, Dr Lally assumes that, for major new capex, the entire funding occurs at a single point in time. It would be a straight forward matter for the Commission to verify that this is not the case. For major capex, for which there can be lengthy build periods, the funding can occur on a staggered basis, more consistent with TACD than ROTD.

¹ Dr Lally, Review of further WACC issues, 22 May 2016.

² Frontier Economics, Issues arising from Commerce Commission workshop, 4 October 2016, paragraph 3f.

³ Frontier Economics, Issues arising from Commerce Commission workshop, 4 October 2016, paragraph 54b.

⁴ Frontier Economics, Issues arising from Commerce Commission workshop, 4 October 2016, paragraph 54c.

⁵ Frontier Economics, Issues arising from Commerce Commission workshop, 4 October 2016, paragraph 54d.

Aurora was somewhat surprised by Commissioner Begg's comment, at the WACC conference, that *"parties don't seem to have commented on Martin's analysis which was put out in May specifically"*⁶.

Our previous submission on WACC detailed why we didn't consider Dr Lally's reasoning against TACD to be persuasive⁷. Moreover, we noted that *"While Lally claims that "unlike the submissions" his assessment is "quantified and balanced against a wider set of considerations", the rationale provided in our submission ... and others is tightly linked to the one consideration that matters; the Commerce Act statutory objective and legislative requirements" [footnote removed]*⁸. As a consequence, our submissions focussed on how ROTD v TACD stacked up against the statutory objective, as a response to Dr Lally's NPV analysis⁹.

We also recommended that Dr Lally's analysis should be peer reviewed¹⁰ which, in the absence of the Commission obtaining such review, Frontier Economics has now, helpfully, undertaken,

3 Where to from now?

The position the Commission is now in is somewhat unusual. If the Commission continues to accept the advice from Dr Lally on ROTD v TACD, particularly the NPV analysis, then it is basically saying all regulated suppliers (including all electricity networks) that have submitted on this matter are wrong that TACD would better protect their commercial position than ROTD.

We reiterate our view that if the Commission intends to accept the advice from Dr Lally, in favour of ROTD, be it in terms of the risk free rate or debt risk premium, then it should seek independent peer review of that advice. The peer review should also extend to submissions, including the Frontier Report. The Commission adopted this approach for the WACC percentile review, and we consider that set a very good precedent; particularly for decisions on contentious matters.

⁶ Commerce Commission, transcript, WACC Workshop Held Wednesday, 7 September 2016, page 115.

⁷ Aurora Energy, Submission, Input Methodologies Review: Draft Decision and Determination Papers, 4 August 2016, page 10.

⁸ Aurora Energy, Submission, Input Methodologies Review: Draft Decision and Determination Papers, 4 August 2016, page 10.

⁹ Aurora Energy, Submission, Input Methodologies Review: Draft Decision and Determination Papers, 4 August 2016, pages 10 and 11.

¹⁰ Aurora Energy, Submission, Input Methodologies Review: Draft Decision and Determination Papers, 4 August 2016, pages 9 and 10.