Aurora
ENERGY LIMITED

Submission

Input Methodologies Review: Draft Decision and Determination Papers

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DELTA
THINK.INFRASTRUCTURE

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1 EXECUTIVE SUMMARY

Aurora considers that the Commission's IMs review process is largely sound.

Aurora appreciates the use of workshops, the Commission's early engagement, regular consultation, and release of expert reports prior to draft decisions. We also consider the Commission's use of external experts reflects regulatory good practice.

We support the evolutionary approach whereby Commission "will identify further opportunities for improvement and continue to refine solutions to issues. Longer term we also expect scope for change to suit a landscape where we have better knowledge of performance and are able to rely more on existing information"[1] and "In the short term, we intend to continue to evolve the regime by increasing consideration of supplier-specific circumstances in the default path where possible, and reducing the cost and complexity of the CPP process"[2].

Aurora agrees the changes to the IMs should be largely incremental. This is consistent with promoting regulatory certainty and predictability. It is also consistent with the outcomes of the High Court Input Methodologies (IMs) Merit Appeal decision.

Aurora has repeatedly requested that the Commission confirm its position on the High Court's consideration of "*reasonable investor expectations*". We consider it broadly consistent with the Commission's key economic principle of "Real financial capital maintenance"[3]. We are disappointed that, to date, the Commission has only relied on, or referred to, reasonable investor expectations in the context of the TSLRIC price determination for Chorus' UCLL and UBA services. We consider that providing regulated suppliers with confidence that reasonable investor expectations will be met and protected are important components of achieving regulatory certainty and predictability.

We support the Commission's draft decision to apply a revenue cap for EDBs in future resets, and to allow for accelerated depreciation. We question whether the Commission has gone far enough on accelerated depreciation when compared to the UCLL and UBA price determinations, and Telecommunications Act precedent more generally.

We also support the Commission's position on the treatment of emerging technology, and the cautious approach it is taking to the cost allocation IMs and related party transaction (RPT) rules. The RPT rules are already cumbersome and restrictive. We consider they should be reviewed to provide more flexibility; e.g., allowing for RPTs based on avoided costs of distribution, rather than tightening the rules further still.

At present, no evidence has been provided, by the Commission or any submitter (including ERANZ who dealt with the issue in detail) to indicate the cost allocation and RPT rules need tightening.

Tightening the rules (including further limits on application of ACAM) would most likely unduly inhibit incentives to invest in non-regulated activities, and restrict the ability of EDBs to adopt non-traditional technology options which could improve efficiency/reduce costs. While such outcomes would reduce the competitive pressure gentailers could face from emerging technology, it would not be to the long-term benefit of consumers or consistent with outcomes in workably competitive markets.

The area where Aurora considers the Commission has taken a substantive misstep is in relation to the issue of whether the current prevailing rate approach to determining WACC should be replaced with a trailing average cost of debt (TACD) approach. We believe a TACD approach

[1] Commerce Commission, Input methodologies review draft decisions, Topic paper 2: CPP requirements, 16 June 2016, paragraph 36.

[2] Commerce Commission, Input methodologies review draft decisions, Topic paper 2: CPP requirements, 16 June 2016, paragraph 37.

[3] Commerce Commission, Input methodologies review draft decisions, Framework for the IM review, 16 June 2016, paragraph 122.1.

would create a win-win situation for consumers and regulated suppliers. Prices would not be higher or lower over the 5-year DPP regulatory period simply due to luck over what the risk-free rate is in a single one-month period (or three months, under the Commission's proposal). All it would take, by way of example, is for interest rates to be abnormally low (high) in three one-month periods, and prices would be too low (high), based on regulated suppliers' efficiently incurred cost of debt for a 15 year period. There is a 1 in 4 (25%) chance of this happening. This would be inconsistent with reasonable investor expectations, setting prices on the basis of current and forecast profitability and incentives to invest (limiting excessive returns).

We generally think the Commission's CPP proposals are sensible. Expanding the extent to which DPP reopeners can apply is a particularly sensible way of reducing the need for CPP applications.

However, the current CPP arrangements, even coupled with the Commission's proposals, remain a concern. We see them as a substantial impediment to CPP applications, particularly for small and mid-sized EDBs. Regulated suppliers could be placed in a position where a DPP does not satisfy reasonable investor expectations, or enable recovery of a normal return on investments, but regulated suppliers would still not apply for a CPP.

We recognise this is not an easy area to resolve. Decisions to change DPP settings to allow higher prices and/or lower service quality should not be made lightly given the impact on consumers. One of the most fruitful potential options, in our view, would be to allow single issue CPP applications. We see the current grid-upgrade approval provisions for Transpower as a successful and relevant precedent. We are not aware of any problems arising from these arrangements. Quite the opposite. The approval process works well and has ensured prudent and efficient transmission investments.

2 INTRODUCTION

Aurora Energy welcomes the opportunity to submit in response to the Commerce Commission's draft decision and determination papers on the statutory Input Methodologies review. All prior submissions on the IMs review form part of our submission on the draft decision papers.

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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3 IMs REVIEW PROCESS IS FUNDAMENTALLY SOUND

Aurora has been pleased with the general approach the Commission has taken to the IMs review, including early consultation on matters such as problem definition, and use of industry forums etc. as part of the process. We have commented favourably on various aspects of the process in previous submissions.

While the Commission's process has a number of positive attributes, we are unhappy that the Commission and Electricity Authority failed to co-ordinate their respective consultation timetables on the IMs review, and the transmission pricing methodology (TPM) and distributed generation pricing principles (DGPPs) reviews. These are substantial issues, and the overlap in the final stages of the reviews should have been avoided; particularly as both regulators are working to self-imposed deadlines for completion prior to Christmas.

We appreciate the extensions the Commission has granted, but the overlaps have impacted on our ability to engage to the extent we would have liked, including the nature of evidence provided in our submission. Given the volume of material the Commission has released, 10 weeks is not a long time for stakeholders to prepare submissions, even absent the TPM and DGPP consultations.

This situation would not have eventuated if the Commission had accepted our recommendation not to effectively fast-track the IMs review, and to keep to the time-frame required by the Commerce Act.

4 ENHANCING REGULATORY CERTAINTY AND PREDICTABILITY

A recurring theme through the IMs review has been the importance of regulatory certainty and predictability. In our last submission, we noted that we recognise the High Court Merit Appeal decision, and the need for regulatory certainty, count against substantive reform.

Our previous submissions, including in the DPP reset decision, also emphasised "*reasonable investor expectations*" – surety that regulated suppliers will be able to recover the costs of prudent and efficient investments[4] – is an important aspect of regulatory certainty and predictability.

[4] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], paragraph [605].

This principle is relevant to much of the decisions the Commission makes on the IMs. For example, this is one of the reasons we don't support a cap on the wash-up amount that prevents regulated suppliers from recovering the full losses from catastrophic events.

Regulatory certainty and predictability is something that, if the Commission operates Part 4 and the IMs well, will develop and improve over-time as regulated suppliers and consumers build trust and confidence in the way the Commission operates, and in the predictability of decision-making. If the Commission builds trust and confidence in the way it operates there is no need for *"seven years [to be] the maximum amount of certainty as to the rules the regime provides"*[5].

We acknowledge that the Part 4 regime has generally evolved in a sensible and predictable manner. For example, the Commission has increased the range of supplier-specific circumstances taken into account subsequent to the first 2009 DPPs, while maintaining the relatively low-cost purpose of the DPP, and other positive changes such as IRIS, attempted service quality-revenue linking, and an expanded range of recoverable and pass-through costs.

The incremental (only) changes the Commission is proposing are consistent with this, and what we would expect given that the High Court Merit Appeal largely confirmed that the IMs satisfy the statutory objectives. In some aspects, notably the use of a trailing average cost of debt (TACD), the Commission has erred too far in favour of the status quo – which could result in an opportunity for a 'win-win' for both regulated suppliers and consumers being lost. Aurora does not consider proposals that would make all parties better off would harm regulatory certainty in anyway.

Regulatory certainty and predictability is also enhanced by ensuring differences in approach to different jurisdictions (e.g., Part 4 of the Commerce Act and Part 2 of the Telecommunications Act), and amongst regulators, are transparent and reasonably justified on the basis of legislative or industry specific differences.

In this respect, we have previously commented on aspects of the Commission's decisions in relation to the DPP reset and the UBA and UCLL price determinations[6].

We are also nervous that the Commission and Electricity Authority seemingly havie divergent views on areas where their roles overlap, which we consider harms regulatory certainty. For example:

- The IMs allow ACOT payments for distributed generation, but the Authority's proposals would make these IM provisions unworkable; and
- The Commerce Commission considers (correctly in our view) that a revenue cap would increase EDBs incentives to improve the efficiency of their distribution pricing arrangements, while the Authority holds the opposite view; and

5 EMERGING TECHNOLOGY WILL BECOME A CRITICAL ISSUE

Aurora supports the Commission's position that "We would not want the IMs or our regulatory regime more generally to discourage suppliers (or others) from using new technology and new business models for their and consumers' benefit"[7].

We agree with ENA "that concerns about ENBs competing in emerging technology markets are unfounded and misconstrue some of the regulatory requirements and commercial realities that apply to ENBs"[8].

While we understand gentailer interest in EDB engagement in such activity, which could increase the level of competition they face, what matters is the long-term interests of consumers, not

[5] Commerce Commission, Input methodologies review draft decisions, Topic paper 4: Cost of capital issues, 16 June 2016, paragraph 346.2.

[6] For example: Aurora Energy, Input methodologies review: Update paper on the cost of capital topic, 5 February 2015, section 9.

[7] Commerce Commission, Input methodologies review draft decisions, Topic paper 3: The future impact of emerging technologies in the energy sector, 16 June 2016, paragraph X7.

[8] ENA, Submission on IMs review: emerging technologies, 4 February 2016, paragraph 7.

suppliers. ENA noted they "*would also be concerned if parties were seeking regulatory intervention to remove ENBs as potential competitors from emerging technology services markets*"[9].

Interestingly, though, much of the ERANZ discourse on EDBs and emerging technology has direct parallels with concerns about generator/retailer integration, and the implications for independent retailers[10].

While ERANZ has strongly asserted that the cost allocation IMs result in "*excessive advantages*" to EDBs, and promote outcomes that are injurious to competition, they have provided no evidence to support their detailed claims[11]. We note the High Court position in the IMs Merit Appeal decision that "*Where a proposition is simply asserted ... we give it little or no weight*"[12].

Other submissions explained why the ERANZ position is unfounded or incorrect. For example:

> "*Under the ABAA method, causal or proxy cost allocators must be applied and these are subject to audit scrutiny and disclosure to the Commission. The ACAM approach only applies where materiality thresholds are not reached (i.e. where the unregulated activity is not material), and involves allocations of shared costs between regulated and non-regulated services – contrary to the perception of some workshop participants that all costs/assets are allocated to regulated services.*"[13]
>
> "*By allocating costs or assets out of the regulated business, the unregulated activity needs to be sufficient to cover those costs. Regulated revenues fall as a result of allocating costs out of the regulated business*"[14]
>
> "*It is important to recognise that cost allocation only applies to a subset of expenditures by any EDB. A clear majority of EDB costs are directly attributable to particular regulated or unregulated services. Cost allocation applies only to corporate overheads and a few other shared costs or assets.*
>
> *Our analysis of information disclosure data demonstrates that EDB investments in shared assets are not material relative to the size of the businesses concerned and we consider ACAM is appropriate in such circumstances. While shared operating costs are more material, only some EDBs are able to apply ACAM for opex, which is the expected outcome. Overall the data does not suggest that the ACAM thresholds are unsuitable.*"[15]
>
> "*The ability to roll capital assets into the RAB only applies to the extent that assets are used to provide regulated services. Where the asset is used to supply competitive services, there is no RAB 'protection'*"[16].

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[9] ENA, Submission on IMs review: emerging technologies, 4 February 2016, paragraph 28.

[10] We agree that the ERANZ/retailer separation rule proposals are outside of Commission's scope/mandate. The ERANZ proposals may be more useful if the Government or Electricity Authority decided to adopt separation arrangements for retailing and generation activities, than for the IMs review.

[11] ERANZ, Submission on Emerging Technologies - Workshop and Pre-workshop paper, 4 February 2016, section 4.1.

[12] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], paragraph [1745].

[13] ENA, Submission on IMs review: emerging technologies, 4 February 2016, paragraph 51.

[14] Unison, Submission on the Input Methodologies: Treatment of Emerging Technologies, 4 February 2016, paragraph 24(a).

[15] PwC, Submission to the Commerce Commission on Input methodologies review: Emerging technology pre-workshop paper, 4 February 2016, paragraphs 21 and 22.

[16] Vector, Submission on emerging technology pre-workshop paper: 30 November 2015, 4 February 2016, paragraph 21.

The High Court Input Methodologies Merit Appeal decision[17] also reviewed the cost allocation IMs and observed that the Commission's application of section 52A(1)(c)[18] and section 52T(1)(a)(iii)[19] results in a sharing of efficiency gains from operation of unregulated services by sharing shared and common costs between the regulated and unregulated businesses, resulting in lower regulated network prices if regulated businesses engage in unregulated activities.

We also note that, while the Electricity Authority considers it important "to better understand the incentive effects of the cost allocation approach on efficiency and competition in the broader electricity market"[20], they have not raised or identified any evidence or specific examples of actual problems, despite the work they have done on emerging technologies and their wider electricity industry remit. In fact, based on the Electricity Authority assessment of electricity distribution pricing and emerging technology, the only evidence they have raised suggests the opposite concern to ERANZ. EDBs may be over-encouraging alternative providers of emerging technology such as solar[21].

6 PROMOTE AND PROTECT INCENTIVES TO INVEST

It is important to ensure regulated suppliers have incentives to adopt the most efficient investment/operational approach, including in relation to new and emerging technology.

We would be very wary of any moves to tighten, further still, the rules around related party transactions (RPTs) and cost allocation. We support the Commission taking a cautious approach to reform in this complex area. It is prudent to hold off making a decision given the Commission does "*not have a complete problem definition*" and there are "*likely benefits from taking more time*"[22].

We agree with ENA that "More stringent requirements regarding the allocation of costs and asset values would be likely to be contrary to section 52T(3), where the Commission is required to ensure that the cost allocation IM does not unduly deter investments by regulated suppliers in unregulated activities"[23]. We, accordingly, don't support the Commission's proposal to reduce the materiality threshold for applying ACAM from 20% to 10%.

Aurora has previously detailed concerns that the RPT rules are problematic. In our view, the Commission should review the RPT rules to ensure they can be applied in the circumstances where they are appropriate.

Looking at different scenarios, as the Commission has been doing, is a good starting point. The Commission should also consider whether an approach based on the avoided cost of distribution (with the avoided cost of transmission (ACOT) regime as a precedent[24]) would be appropriate.

We also consider that the director's certification option should be widened, and not just apply when no other option is available.

We agree with Unison that "The related party transaction rules are currently inconsistent between the treatment of opex and capex and may not allow for efficient charging approaches"[25] and

[17] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v C OMMERCE COMMISSION [2013] NZHC [11 December 2013], PART 8 – VECTOR'S COST ALLOCATION APPEAL.

[18] Which "stipulates as an outcome to be promoted by Part 4 regulation, consistent with outcomes produced in workably competitive markets, that suppliers of regulated goods and services … Share with consumers the benefits of efficiency gains in the supply of regulated goods or services …" [paragraph 1799].

[19] Which "requires an IM to be developed for the "allocation of common costs, including between activities, businesses, consumer classes, and geographic areas"" [paragraph 1800].

[20] Electricity Authority, Implications of regulatory treatment of cash flows for emerging technology, 1 June 2016, page 2.

[21] Electricity Authority, Consultation Paper, Implications of evolving technology for pricing of distribution services, 3 November 2015.

[22] Commerce Commission, Input methodologies review draft decisions, Topic paper 7: Related party transactions, 16 June 2016, paragraph X6.

[23] ENA, Submission on IMs review: emerging technologies, 4 February 2016, paragraph 52.

[24] Electricity Industry Participation Code 2010, schedule 6.4.

[25] Unison, Submission on the Input Methodologies: Treatment of Emerging Technologies, 4 February 2016, paragraph 27.

"Restrictively the rules focus on cost-based methods which may not always be appropriate or workable, or evidence of market-based transactions, where these may not exist"[26].

The Commission faces a difficult balancing act between ensuring that cost allocation and RPT rules do not result in cross-subsidies, but also do not thwart incentives of regulated suppliers to invest.

Another aspect of providing incentives to invest, is to ensure reasonable investor expectations are met, and regulated suppliers can recover the cost of their prudent and efficient investment. To this end, we support the Commission's draft decision to shift EDBs from a price cap to a revenue cap, and to allow adoption of accelerated depreciation.

The Commission's draft approach does, if anything, seem unduly cautious with only modest accelerated depreciation. The acceleration provided for seems low relative to the approach for Chorus' UCLL and UBA businesses, and we query how the Commission's desire to avoid/mitigate short-term price increases (even though they are NPV neutral) sits with statutory objective.

7 AURORA SUPPORTS ADOPTION OF A REVENUE CAP

Aurora supports the Commission's draft decision to shift from a price cap to a revenue cap.

The proposed design of the revenue cap is generally sound

Aurora also considers the Commission's proposed design of the revenue cap arrangements appears to be sensible. In particular:

- We support adoption of a "pure revenue cap";
- We support adoption of a wash-up mechanism;
- We support application of a time value of money adjustment;
- We support a constraint on the average price increase in each year, to minimise price shocks for consumers; and
- We support adoption of a wash-up account.

We question whether a "cap and collar" on the annual draw down amount is needed to reduce price volatility, given the Commission is proposing a constraint on the average price increase in each year.

We also don't support a cap on the amount that can be washed up, to force regulated suppliers to bear some of the losses associated with a catastrophic event. EDB views on the need to fully compensate (either ex-post or ex-ante) regulated suppliers for catastrophic events have been canvassed in detail in submissions on the Orion CPP. Full compensation is also needed to meet reasonable investor expectations and satisfy the Commission's key economic principle of "*Real financial capital maintenance*"[27].

In addition, consistent with our previous recommendations[28], we support the Commission's position not to adjust asset beta for differences in systematic risk due to regulatory differences, and Dr Lally conclusion that "*there is no empirical study that provides a clear conclusion on the effect of regulation on beta*"[29].

[26] Unison, Submission on the Input Methodologies: Treatment of Emerging Technologies, 4 February 2016, paragraph 5.

[27] Commerce Commission, Input methodologies review draft decisions, Framework for the IM review, 16 June 2016, paragraph 122.1.

[28] Aurora Energy, Input methodologies review: Update paper on the cost of capital topic, 5 February 2015, section 7.

[29] Dr Martin Lally, Review of WACC issues, 25February2016, page 20.

There are sound reasons for a revenue cap

Aurora supports a revenue cap for a number of reasons, including:

- It reduces, but does not remove, the risk that emerging technology will undermine the ability of regulated suppliers from recovering a normal return on their prudent and efficient investment in any particular regulatory period;
- It reduces the impact of forecasting errors in the DPP resets – changes in technology and patterns in demand are changing the trends in load growth and making forecasting more difficult;

Aurora is pleased the Commission has adopted our (and others) recommendation and "*conducted analysis to examine the materiality of the quantity forecasting risk for EDBs over the 2010-2015 price-path*"[30]. The Commission's analysis highlights there is a material problem with quantity forecasting, even if it "*is fairly accurate on average across all EDBs*"[31] that undermines the ability of EDBs to recover their costs.

- Aurora agrees with the Commission's assessment that a revenue cap would improve incentives for EDBs to adopt, or shift to, more efficient electricity distribution pricing methodologies.

Problems with the Electricity Authority's analysis of a revenue cap

We were surprised, and disappointed, by the Electricity Authority's conflicting view on the implications of a revenue cap versus price cap on incentives for efficient distribution pricing. In responding to the Electricity Authority's letter to the Commission on this matter, we have treated the Authority's correspondence as, effectively, an early submission, and our response forms what otherwise would have been part of a cross-submission.

We consider the Electricity Authority's analysis to be somewhat one-dimensional, and that it places far too much weight on (theoretical) impacts of a price or revenue cap on EDBs incentives. We think it is safer to rely on evidence-based decision-making. The examples the Electricity Authority uses would be more useful if they were backed up by real-world examples. Application of revenue caps is common so there should be plenty of examples of distribution pricing the Authority could draw on to test its analysis.

The Electricity Authority's suggestion EDBs should be subject to quantity risk because "*Forecasting sales is a risk that nearly every business faces*"[32] fails to recognise that firms in workably competitive markets are not exposed to quantify risk arising from regulatory errors.

The Electricity Authority has suggested that "Under a WAPC … the prospect of declining energy volumes due to increasing penetration of emerging technologies (such as solar panels) may provide a stimulus to distributors to change their pricing structures"[33].

EDBs face incentives to adjust prices to address declining energy volumes due to increased penetration of emerging technologies, regardless of whether they operate under a price cap or a revenue cap. Whether EDBs operate under a price or revenue cap is only one aspect of their incentives that need to be considered.

It would be very short-sighted for EDBs to take the view that if they are under a revenue cap they are "*insulated from the risk of revenue loss … because revenue would not depend on energy volumes, as any revenue shortfalls would be recovered in the annual wash-up*"[34]. Similarly, the

[30] Commerce Commission, Input methodologies review draft decisions, Topic paper1: Form of control and RAB indexation for EDBs,GPBs and Transpower, 16 June 2016, paragraph 37.

[31] Commerce Commission, Input methodologies review draft decisions, Topic paper1: Form of control and RAB indexation for EDBs,GPBs and Transpower, 16 June 2016, paragraph 37.

[32] Electricity Authority, Possible implications for efficient distribution pricing of a decision to change the form of control for electricity distribution businesses, 30 May 2016, page 8.

[33] Electricity Authority, Possible implications for efficient distribution pricing of a decision to change the form of control for electricity distribution businesses, 30 May 2016, page 2.

[34] Electricity Authority, Possible implications for efficient distribution pricing of a decision to change the form of control for electricity distribution businesses, 30 May 2016, page 2.

Electricity Authority's suggestion that "*a revenue cap could provide incentives for distributors to set inefficiently high prices for price-responsive services and/or customers … The risk appears to be that under a revenue cap, a business may have an incentive to set prices above the unrestricted monopoly level for price-responsive services in an effort to drive down costs*"[35] is very theoretical.

Either way, if EDBs adopted such approaches they would be financially vulnerable to changes in the way Part 4 is operated; particularly as it would provide evidence they weren't operating efficiently or managing their risk prudently. Successful operation of electricity networks requires continued utilisation of existing (fixed and sunk) assets, not over-encouragement of consumers to adopt alternative technologies.

The incentives on EDBs are not one dimensional. There are various elements that the Electricity Authority and Commission need to consider. For example, an incentive under a price cap can be to overstimulate demand because EDBs can profit by 'beating' the price cap demand growth assumptions. This could bring forward investment and raise distribution costs.

If the Electricity Authority's analysis was correct, we would expect to see EDBs setting variable charges too low, rather than too high, to stimulate demand and maximise revenue under a price cap. The fact that we don't observe this reflects that there are multiple different incentives facing EDBs. Operation of a price cap versus revenue cap is only one element of these incentives.

In summary, the Electricity Authority has considered theoretical potential issues with a revenue cap, while ignoring the adverse efficiency impacts of a price cap. The practical reality is that they both have pluses and minuses that need to be weighed up. The Commerce Commission has appropriately done this to reach a conclusion that a revenue cap should be adopted in the future.

It is also disappointing that, while the Electricity Authority is at a discovery stage of considering the impact of a price versus revenue cap on efficient distribution pricing, it would suggest that it may not be able to rely on EDB incentives to operate efficiently, and may need stronger regulation, if a revenue cap is adopted. Stating that the Authority "*cannot prejudge the outcome*"[36] of its distribution pricing review does nothing to allay these concerns, given that the rest of the content of the letter does precisely that.

8 TRAILING AVERAGE COST OF DEBT SHOULD BE ADOPTED

Aurora is disappointed with the Commission's draft decision to accept Dr Lally's advice, and retain a prevailing rate approach over a trailing average cost of debt (TACD). We recommend the Commission reverse its position.

We do not consider that our previous submissions on WACC and the TACD were adequately considered, as part of Dr Lally's review of submissions or the subsequent draft decisions. In our view, while Lally did not dispute the points we made, he downplayed them without evidence or adequate reason. These submissions should be treated as part of the current submission.

Peer review of Dr Lally's advice should be sought

Aurora recommends that the Commission seek peer review of the advice Dr Lally has provided on prevailing rate versus TACD.

[35] Electricity Authority, Possible implications for efficient distribution pricing of a decision to change the form of control for electricity distribution businesses, 30 May 2016, page 3.

[36] Electricity Authority, Possible implications for efficient distribution pricing of a decision to change the form of control for electricity distribution businesses, 30 May 2016, page 4.

We recommend this for a number of reasons.

First, Dr Lally is not a neutral party on this matter. He advised Queensland Competition Authority against a trailing average approach.

Second, we consider Dr Lally's advice to be out-of-step with recent regulatory developments. The only Australian regulator that has considered trailing average versus prevailing rate, and retained prevailing rate, is the Queensland Competition Authority, on the advice of Dr Lally.

Third, Dr Lally relies on his own analysis to conclude "recent analysis strengthens the case for the Commission's continued use of the on-the-day regime"[37]. For example, this includes analysis which purports that "imperfections in the process by which businesses subject to the on-the-day regime hedge the risk-free rate component of their cost of debt (a regulatory window for averaging the risk-free rate that is shorter than firms require for hedging, and the use of the swap rate to hedge the government bond rate) have been shown to be inconsequential"[38]. This analysis should be peer reviewed.

Dr Lally provides weak justification for retention of prevailing rate

We do not consider Dr Lally's reasoning against TACD to be persuasive. For example:

- There is no reason to believe a prevailing rate approach would better preserve NPV=0 than trailing average (quite the opposite, as a trailing average would better match the regulated WACC with regulated suppliers' efficient and actual cost of capital).
- Dr Lally suggests "*likely MRP estimation errors*" are partly offset by "*mismatches between the DRP allowed under the on-the-day regime and the trailing average DRP*"[39]. One error should not be used to correct another. Both errors should be directly remedied. The fact that Dr Lally considers that the use of prevailing rate results in an error in the estimation of WACC strengthens the case for TACD. Further, Dr Lally provided no evidence of the extent to which the two errors offset each other, or of their correlation.
- Dr Lally suggests "*policy reversals incur administrative costs and may also inflict large one-off gains or losses on to regulated businesses*"[40]. Dr Lally provides no evidence to support these assertions. A simple examination of experience with change from prevailing rate to TACD in Australia would prove neither points are valid.
- Also, by example, given the DPP (and WACC) reset occurs every 5 years the 'law of large numbers' cannot be relied on to average out wins and losses from fluctuations in interest rates[41]. It would take 25 years to obtain a mere 5 one-month sample points. By the time the law of large numbers kicked in, we would all be dead.

Rationale for TACD over prevailing rate is sound

While Lally claims that "unlike the submissions" his assessment is "quantified and balanced against a wider set of considerations"42, the rationale provided in our submission (not referred to by Lally in this context) and others is tightly linked to the one consideration that matters; the Commerce Act statutory objective and legislative requirements.

In our previous submission, for example, we noted a prevailing rate approach (compared to a trailing average approach) unambiguously fails against various aspects of Part 4[43]:

[37] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 3.

[38] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 3.

[39] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 4.

[40] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 4.

[41] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 30.

[42] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 7.

[43] Aurora Energy, Input methodologies review: Update paper on the cost of capital topic, 5 February 2015, sections 1.1 and 4.

- It scores poorly in terms of measuring "current" and "forecast" profitability as required for the purpose of price resets;

  Lally: "*regulatory use of the trailing average risk-free rate reduces differences between the regulatory WACC and the business's actual rate of return*"[44].

- It means the regulated WACC can be expected to either exceed the actual cost of capital (contrary to the objective of limiting excessive returns), or be less than the actual cost of capital (contrary to reasonable investor expectations), rather than being a reliable estimate of WACC;

- It is contrary to replicating workably competitive market outcomes;

- It promotes inefficient behaviour (by regulated suppliers changing their behaviour to reduce exposure to risk that their actual cost of capital will differ from the regulated WACC); and

  Lally: "*This point is correct*"[45].

- where it results in a DPP WACC higher than the CPP WACC (or results in an exaggerated differential) it acts as a barrier to regulated suppliers applying for CPPs.

  Lally: "*this is true in principle*"[46].

A trailing average approach also creates a win-win for consumers and regulated suppliers, so arguments about regulatory certainty are irrelevant.

Nothing in the Lally advice, or the Commission's draft decision, would suggest any of these points are incorrect (quite the opposite).

9 USE OF DPP WACC FOR CPPs

The proposal to simply set the CPP WACC equal to the DPP WACC is, in many ways, a pragmatic solution to a prevailing problem, but is only valid in circumstances where the CPP WACC would otherwise be lower than the DPP WACC. The solution fails in circumstances where the opposite is the case.

We agree with Vector's position on this matter:

> *"As acknowledged by the Commission, the current WACC IM gives rise to very volatile changes to the estimate of WACC from year to year. Such volatile changes to the estimate of WACC would apply to any CPP application made during the year. Accordingly, WACC becomes a meaningful consideration, and potentially a disincentive or incentive, for businesses wishing to apply for a CPP.*
>
> *However, Vector does not support the ENA's recommendation of making a CPP WACC equal to the prevailing DPP WACC. Rather, Vector believes the most important issue for*

[44] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 4.

[45] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 34.

[46] Dr Martin Lally, Review of further WACC issues, 22 May 2016, page 34.

> *the IM review is to address the causes of volatility within the WACC IM. Vector supports improvements recommended by CEG to the WACC IM such as moving to a 10 year government bond, removing the volatility of 'prevailing' estimates, moving to a trailing average cost of debt and applying an internally consistent approach to the estimate of cost of equity risk-free-rate and tax-adjusted market risk premium to ensure the Commission's estimate of WACC is much more durable over time."*[47]

If interest rates increase after a DPP is set, and the Commission continues to apply a prevailing rate approach, this would create a situation where a regulated supplier wanting to apply for a CPP to enable capex beyond the 'business-as-usual' capex assumed in the DPP would not, initially at least, be able to fully recover the cost of capital from funding that new additional capex.

The 'solution' fails to recognise the disparity between the DPP and CPP WACC is not the problem, but rather is a symptom of a broader underlying problem with the current cost of capital IMs and use of the prevailing rate approach.

10 GAS & ELECTRICITY ASSET BETA ARE SEPARATE ISSUES

The Commission's proposal to lower the asset beta for gas to match that of electricity networks will inevitably be controversial.

In our view, the issue has parallels with WACC percentile.

The Commission may want to err on the side of providing or retaining a higher gas beta, even if the evidence on the matter is limited, in order to provide greater surety that gas pipeline businesses will be able to fully recover the cost of their prudent and efficient investment.

It is potentially harmful to regulatory certainty and predictability, for the Commission to link this issue with the electricity asset beta, by suggesting that if gas retains a higher asset beta then it may be the case that electricity should have a lower asset beta.

Any such linking would mean attempts to reduce the risk that the gas WACC is too low, would heighten the risk the electricity WACC would be too low.

The question of whether the gas electricity beta should be higher than the electricity asset beta needs to continue to be considered separately from the setting of the electricity asset beta.

11 WACC – NO FURTHER WORK REQUIRED

Consistent with our previous submission to the Commission, we welcome the confirmation that the Commission is not progressing further Black's Simple Discount Rule, a split WACC or re-visiting of the WACC percentile decision.

12 LOWER COST CPP ARRANGEMENT NEEDED

As a starting point, consideration of the CPP arrangements should recognise the varying size of different EDBs.

It is positive that the Commission "*acknowledge[s] the increased burden that a CPP could potentially be for small suppliers*"[48].

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[47] Vector, Input methodologies review – update paper on the cost of capital topic, 9 February 2016, paragraphs 2 and 3.

[48] Commerce Commission, Input methodologies review draft decisions, Topic paper 2: CPP requirements, 16 June 2016, paragraph 203.

The current CPP arrangements impose substantial financial and resourcing challenges, which larger EDBs would struggle with, let alone small or mid-sized EDBs. This is a substantial impediment to EDBs applying for a CPP, even if a DPP was not adequate to satisfy reasonable investor expectations, or to enable recovery of a normal rate of return.

Overall, we consider the Commission's proposed changes to the CPP arrangements to be sensible.

We particularly welcome expansion of DPP reopeners (including expansion of the error reopener, creation of a quality standard reopener, and creation of a reopener to address any problems caused by major transactions). These should help reduce the need for CPP applications.

The proposed CPP changes only go part way to removing the substantive barriers faced by small and mid-sized EDBs, though.

Previous Commission analysis suggested it could be optimal to provide smaller EDBs an uplift on their prices (separate to the matter of the WACC percentile) to minimise the risk that their circumstances would warrant a CPP application.[49]

We support provision for 'single issue' CPPs. This would enable low cost CPPs which don't require an opening of the entire books.

This would mirror arrangements for Transpower grid-upgrade approvals. We consider that the grid-upgrade provisions provide a relevant and useful precedent. The operation of the grid-upgrade provisions has been very successful, as highlighted by the Government currently considering extending these arrangements to Chorus, under the Telecommunications Act[50].

<u>*Consumer Engagement Guidelines may be desirable*</u>

It may also be desirable to develop consumer engagement guidelines to clarify what is required to meet the CPP consumer consultation requirements, and to avoid the problems that arose with the Orion application. This could be done as part of the CPP IM or separate guidelines.

Orion is the only energy network that has applied for a CPP, following the Christchurch earthquakes. The Commission didn't think Orion's consumer engagement on different options for repair of the network was adequate.

Vector's take on this was that "*Orion's consumer engagement complied fully with the relevant CPP IM requirements*"[51] and Powerco didn't think there was "*enough guidance on the level of consultation the Commission expected*"[52].

Powerco recommended that "*the Commission specify in more detail what they consider is needed*" and that this information "*could be in a guidance document*"[53]. Energy networks don't need to leave this up to the Commission though. ENA has successfully taken a leadership role with the establishment of working parties, in liaison with the Commerce Commission, to work through regulatory issues like this. The Telecommunications Carriers' Forum has shown the benefit of industry getting together to prepare codes and guidelines for the Commerce Commission.

The consumer consultation guidelines could follow Australian precedent.

One of the Australian Energy Regulator's (AER) initiatives has been a Consumer Engagement Guideline for Network Service Providers.[54] The guideline is intended to help energy networks better engage with consumers. The AER expects this will help ensure services better align with consumer interests. A key principle of the AER is "*a strong consumer engagement framework*" which

[49] Commerce Commission, Revised Draft Reset of the2010-15 Default Price-Quality Paths, 21 August 2012, Appendix J.

[50] Ministry of Business, Innovation and Employment, Telecommunications Act Review: Options Paper, July 2016, section 5.3.2.

[51] Vector, Submission to the Commerce Commission on Orion CPP Draft Decision, 20 September 2013, paragraph 70.

[52] Powerco, Re: Feedback on Setting Orion's customized price-quality path, 14 April 2014, paragraph 9.

[53] Powerco, Re: Feedback on Setting Orion's customized price-quality path, 14 April 2014, paragraph 14.

[54] https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/consumer-engagement-guideline-for-network-service-providers

"*encourages greater involvement and communication between electricity and gas network businesses and the communities they serve*"[55].

13 RELATED PARTY TRANSACTIONS

The Commission has observed that related party operating expenditure has increased in absolute and proportional terms, and that related party capital transactions are a feature of some regulated suppliers' operating expenditure or capital expenditure, but not others.[56]

That related party transactions feature as described is not necessarily a cause for concern, particularly in the provision of traditional services supporting network operation (operations and maintenance, network development, etc.). There are a range of reasons why EDBs would prefer to procure these services from a related party, particularly in regional areas, including more control over safety performance given the recent strengthening of legislative requirements, and control over the availability of skilled resources.

Irrespective of the motivations for procuring services from related parties, a fundamental objective of the related party valuations provisions, whether they reside in the IMs or Information Disclosure, is the recovery of efficient expenditure at prices that would be observed in an arms-length transaction, in a workably competitive market. In Aurora's view, the Commission's focus should lie here, rather than getting tied up in the specific motivations for the existence of related party transactions

There are currently a range of related valuation options within the IMs. Aurora has previously submitted that the current valuation options for related party capital transactions act too rigidly to avoid over-payment by EDBs for related party transactions, and give rise to the opposite problem. Our observation is that, in addition to some valuations options are unworkable, while workable valuation options derive materially different answers[57].

Aurora's view is that the rules for valuing related party transactions must achieve two fundamental outcomes:

1. The resultant valuation must approximate an arms-length transaction in a workably competitive market; and
2. Where multiple valuation methodologies are available to regulated suppliers, each option must in all cases, derive a valuation that is not materially dissimilar.

[55] AER, Overview of the Better Regulation reform package, April 2014, section 1.

[56] Commerce Commission, Input methodologies review draft decisions, Topic paper 7: Related party transactions, 16 June 2016, paragraph 57.

[57] Aurora Energy, Submission on the Commerce Commission's open letter on our proposed scope, timing and focus for the review of input methodologies , 31 March 2015, section 5.1.