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Dear Brett Woods

Consultation on Further work on WACC IM

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to comment on the Commerce Commission's (**Commission**) consultation paper "*Further work on the cost of capital input methodology*" (**Consultation paper**) published on 31 March 2014.

WELL's submission covers the following:

- Procedural matters relating to the Commission's decision to review the Weighted Average Cost of Capital (**WACC**) Input Methodology (**IM**);
- Evidence in support of retaining the 75th percentile of the WACC.

2. Procedural matters

WELL is very concerned about the Commission's decision to review the 75th percentile of the WACC in isolation from the entire WACC IM and outside the standard IM review process. WELL considers that this review has undermined the policy intent behind setting IMs separately from determining the price-quality paths and undermined investor confidence in the stability of the New Zealand regulatory regime.

The policy intention of IMs was to promote certainty regarding the key aspects of the regulatory regime. The intention of the IMs was that they would be:

- pre-determined before the Commission makes the rest of the regulatory decisions that make up the overall price path; and
- set through a robust consultation process, subject to possible appeals and then allowed to remain in place until a mandated review occurs every seven years.

The Commission has discretion over all the other elements and having key inputs pre-determined reduces the level of uncertainty with regards to the likely outcomes of the price path. It also focusses the price path consultation process on other matters which contribute to the overall outcome. This is important for both consumers and investors.

Investors make long term investment decisions based on expectations that the Commission will follow the expected process for reviewing the IMs. Investors should be able to rely on the Commission to do this. Investors reasonably expected a thorough review of the IMs to occur every seven years, with the next review in 2017. The Commission's ad-hoc review of one aspect of the WACC IM sets an undesirable precedent that core aspects of the regulatory regime can be changed at any time. This reinforces why New Zealand is considered to have

an uncertain regulatory regime compared with other countries, such as the UK and Australia, and causes a lack of confidence that due process will be followed.

The WACC IM is one of the most important and complex aspects of the regulatory regime with a large financial impact on Electricity Distribution Businesses (**EDB**) and consequently for the consumers they serve. WELL is also concerned that the process of reviewing just one aspect of the WACC IM over such a short timeframe and concurrently with the consultation process for resetting the 2015-20 Default Price-quality Path (**DPP**) for EDBs introduces significant risk that there is less than optimal attention paid to, and engagement in, each review process by both stakeholders and the Commission.

3. Evidence in support of 75th percentile

The Issues paper published on 20 February 2014 suggests that the onus is on EDBs to present empirical evidence in support of the 75th percentile WACC. WELL considers that the onus should not be placed entirely on stakeholders. The WACC IM is currently based on the 75th percentile and the Commission's decision on this matter was developed through an extended two year consultation process. The onus therefore should also be on the Commission to demonstrate why the status quo is no longer appropriate including producing empirical evidence to support why a change is justified.

Furthermore, as a result of the short timeframe permitted for providing empirical evidence (20 working days), there has been insufficient time for the Electricity Network Association's (**ENA**) expert consultants to develop empirical analysis of the relative benefits and costs of retaining the 75th percentile estimate of the WACC. Given the timeframe, the ENA's consultant has only been able to develop the framework for which the Commission should consider the question of whether to retain the 75th percentile.

Notwithstanding, WELL provides the following justification for retaining the 75th percentile WACC.

3.1. Reasonableness check on the overall WACC

To assess the reasonableness of the overall level of the WACC, WELL commissioned Competition Economists Group (**CEG**) to compare the allowed risk premium (the difference between the WACC and the government bond rate) for New Zealand (**NZ**) EDBs compared with the risk premium allowed for regulated energy utilities in Australia, the United Kingdom (**UK**) and United States of America (**USA**) and advise the implications for the appropriate percentile WACC estimate to apply in NZ. The risk premium shows the difference between the return for taking on risk above the risk free baseline. Analysis of the risk premium, rather than the level of the WACC, enables comparisons to be made across jurisdictions as the effects of differences in the baseline level and exchange rate risk are removed.

CEG's report is attached to this submission. As demonstrated in table 1, CEG's analysis shows that even at the 75th percentile of the WACC the risk premium is substantially less for NZ EDBs than for regulated energy utilities in Australia, the UK and the USA, ranging from 0.9 to 2.9 percentage points less. At the 50th percentile WACC this difference is magnified, ranging from 1.6 to 3.6 percentage points less. At the 50th percentile the risk premium allowed by other energy regulators would be 1.7 to 2.4 times that which would be allowed for NZ EDBs. However there is no reason to believe that investors in NZ require a lower risk premium than investors in these other jurisdictions. It is likely that the less mature regulatory regime in NZ, and the small size of its utilities, would require a higher risk premium.

The CEG analysis demonstrates that it would be inappropriate to replace the 75th percentile WACC with the 50th percentile WACC as such an approach would increase the already existing risk that investors will find NZ regulated utilities less attractive investments than regulated utilities in other jurisdictions, due to the substantially lower risk premium.

Table 1: CEG calculation of international regulatory risk premia

	Midpoint	NZ 75 th percentile	AER Midpoint	UK Midpoint	2014 Midpoint	US 2013-2014 Midpoint
Post tax WACC	6.69%	7.41%	8.10%	3.79%	7.65%	7.66%
5 year Gov. bond rate	3.95%	3.95%	3.51%	-1.45%	1.61%	1.27%
10 year Gov. bond rate	4.55%	4.55%	4.32%	-0.38%	2.77%	2.45%
Risk premium (rel. 5 year rate)	2.74%	3.46%	4.59%	5.24%	6.03%	6.39%
Risk premium (rel. 10 year rate)	2.14%	2.86%	3.78%	4.17%	4.88%	5.21%

Source: CEG, April 2014, page 4.

The CEG analysis casts doubt on whether the 50th percentile or the 75th percentile of the WACC as calculated under the IMs is a best reflection of the return required by investors. The CEG analysis shows that a WACC less than the 75th percentile is unlikely to meet the purpose of regulation under Part 4 of the *Commerce Act 1986* that suppliers have incentives to innovate and invest in replacement, upgraded, and new assets and have incentives to improve efficiency and provide services at a quality that reflects consumer demands (section 52 of the *Commerce Act 1986*). If the Commission intends to adopt the 50th percentile of the WACC, it would need to demonstrate that this value is materially better for meeting the purposes of Part 4. As the above analysis demonstrates and in WELL's view, the 50th percentile WACC provides a further significant dis-incentive for EDB's to innovate and invest. Such an outcome is not in the long term interests of consumers.

3.2. Relative costs and benefits of retaining the 75th percentile

The Electricity Networks Association (ENA) commissioned Incenta Economic Consulting (**Incenta**) to consider the available empirical evidence in support of retaining the 75th percentile WACC, rather than moving to the 50th percentile. As noted by Incenta, given the timeframe available for submissions it is not possible to quantify the costs and benefits of retaining the 75th percentile WACC. Nevertheless, Incenta demonstrates that the qualitative evidence indicates that moving to the 50th percentile would likely have substantial negative net benefits relative to maintaining the 75th percentile. Incenta shows that while the true value of the WACC is unknown, the negative consequences of under-estimating the WACC are significantly greater than the consequences of over-estimating the WACC.

Incenta state that the costs of under-estimating the true WACC value by moving to the 50th percentile would likely be substantial and have long term consequences because:

- *High consequence of under-investment.* The consequence of under-investment in electricity distribution networks is primarily observed through reduced reliability of supply. Empirical studies show that the customer value of reliability is very high. This is because the economic costs resulting from interruptions to supply are large. Consequently under-investment has large economic costs.
- *Likelihood of under-investment.* Investors invest in regulated utilities as a defensive yield stock such that stable returns are expected. When revenues fall the utility must cut costs in order to maintain stable returns to investors. Consequently it could be expected that utilities would increase the riskiness of service performance which would lead to a higher prospect of reduced reliability for customers. This would be partially offset by the risk of EDBs receiving financial penalties for failing to meet the quality targets.
- *Longer-term consequences.* Under-estimating the WACC for a prolonged period could create sovereign risk issues as NZ could become known as an unsafe investment environment for regulated utilities.

Incenta state that the costs of retaining the 75th percentile estimate of the WACC, assuming it could potentially exceed the true underlying value of the WACC, are likely to be very small because:

- *Very small impact on allocative efficiency in electricity consumption.* Empirical evidence shows that consumer demand for electricity is highly inelastic such that the change in the level of electricity consumption in response to changes in prices is likely very small. This is because consumers' value of electricity far exceeds the cost, the network component is only a proportion of total electricity charges¹ and only a proportion of the network component is collected through variable consumption charges.
- *Low likelihood of over-investment in network assets.* Suppliers are unlikely to over-invest because incentive-based regulation, such as that employed by the Commission, creates offsetting incentives not to over-invest, as the benefits of under-spending allowances are temporarily retained until the next regulatory period, and over-investment is transparent and could risk inducing undesirable regulatory responses.

Incenta provides numerous examples of situations where policy makers or regulators have considered it appropriate to err on the side of caution in order to minimise the risk of consumers for having a less robust supply infrastructure and investors recovering less than efficient costs and consequently deferring or foregoing otherwise efficient investments.

WELL does not consider that the 75th percentile of the WACC is an over-estimate of the true underlying value of the WACC and, as shown in section 3.1, may still underestimate the true WACC. Additionally, WELL notes that the 75th percentile does not include compensation for asymmetric risks. As stated by the Commission when it determined the WACC IM:

*"The IM does not make any adjustments to the cost of capital for Type 1 asymmetric risk."*²

Notwithstanding, if the Commission is uncertain of where the true value of the WACC lies, it needs to weigh up the potential consequences of under or over-estimating the WACC. As noted above, it is necessary for the Commission to at least retain the 75th percentile, as the costs of under-estimating the WACC considerably exceed the costs of potentially over-estimating the WACC. Such an approach is consistent with the approach taken by the Commission in 2010 when it determined that the 75th percentile should apply:

*"The reason for the Commission adopting under Part 4 a cost of capital estimate that is above the mid-point is that it considers the costs from the point of view of consumers associated with underestimation of the cost of capital in the Part 4 regulatory setting, are likely to outweigh the short-term costs of overestimation. That is, the Commission acknowledges that where there is potentially a trade-off between dynamic efficiency (i.e. incentives to invest) and static allocative efficiency (i.e. higher short-term pricing), the Commission, under Part 4, generally favours outcomes that promote dynamic efficiency. Accordingly, this consideration has been given greater weight for price-quality regulation than minimising the costs to consumers of regulated suppliers earning excess profits through higher prices in the short-term."*³

¹ The network component, inclusive of distribution and transmission line charges, makes up approximately 34% of total final electricity charges to consumers. Sourced from Electricity Authority, 'Analysis of historical electricity industry costs', January 2014, page 13.

² Commerce Commission, 'Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper', December 2010, paragraph H12.13.

³ Commerce Commission, 'Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper', December 2010, paragraph H11.62.

4. Closing

The above available evidence demonstrates that:

- The 75th percentile estimate of the WACC provides a significantly lower risk premium to investors in NZ EDBs than investors in energy utilities in comparable jurisdictions. Applying the 50th percentile would result in an even lower risk premium for investors in NZ EDBs which could dis-incentivise investment in NZ network assets. This analysis demonstrates that the 75th percentile estimate should at least be retained if not increased.
- If the Commission is uncertain of where the true value of the WACC lies, it should retain the 75th percentile as the potential costs of moving to the 50th percentile far exceed the potential benefits. Explicitly quantifying the costs and benefits would very likely support the current qualitative position.

WELL considers that there is sufficient evidence in support of retaining the 75th percentile of the WACC. If the Commission requires quantitative evidence then it should undertake and consult on such analysis before moving from the status quo.

WELL would welcome the opportunity to discuss with the Commission any of the matters raised in this submission. Please do not hesitate to contact Megan Willcox, Senior Regulatory Economist, on MWillcox@welectricity.co.nz if you have any queries.

Yours sincerely



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