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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

On 31 March the Commission released the paper: *'Further work on the cost of capital input methodologies: Process update and invitation to provide evidence on the WACC percentile'* (Consultation Paper).

Attached to this letter is an expert report "*Rationale for setting the regulatory WACC above the mid-point value*" from Jeff Balchin and Scott Stacey of Incenta Economic Consulting ("Incenta"). Jeff and Scott are aware of the High Court rules for Expert Evidence.

The ENA continues to express strong reservations about reviewing the choice of WACC percentile outside of the scheduled IM review process, where the full inter-relationships with the rest of the IMs could be considered and there would be adequate time to amass all the relevant evidence and undertake comprehensive analysis.

In the time available, the Incenta's report has identified the following factors relevant to the Commission's deliberations:

1. Despite the Court's assertions, it is commonly accepted by regulators that there is a need to err on the side of caution in setting a regulatory WACC because of the asymmetric (adverse) consequences of setting the WACC too

low. In consequence, there are numerous examples of regulators adopting estimates of WACC from the upper end of estimated ranges;

2. The Commission has conflated compensation for asymmetric risks with the setting of WACC (as set out in the Orion CPP Determination) so, if the regulatory WACC were reduced to the mid-point, businesses would expect to make returns less than the regulatory WACC absent any cash-flows to compensate for such risks;
3. The economic costs of setting a WACC that is higher than the true WACC are likely to be minor because demand elasticities for electricity are low, and EDBs are not likely to take the risk of excessive investment being written-off through regulatory efficiency reviews (i.e., allocative and productivity efficiency consequences low). By contrast, consumers place a value on electricity in the order of 100 times the average price, so the economic costs of declines in the levels of reliability would dwarf the marginal gains to consumers of slightly lower prices;
4. The Commission could establish estimates of the costs of lower reliability through engineering studies, which examine how reliability levels might change if certain investments were not undertaken over the next 10 years. Such exercises are, however, likely to take some time to complete but the Incenta report cites as examples the substantial costs of infrastructure failures to illustrate that unreliable infrastructure can result in substantial economic costs.

Taking these factors into account, Incenta concludes that the asymmetry of outcomes from different investment levels provides a strong justification for setting the regulated WACC above the mid-point estimate to ensure that investments proceed.

Overall, the ENA maintains its view that the use of the 75th percentile as the basis for the regulatory WACC remains appropriate.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Alan Jenkins', with a long horizontal flourish extending to the right.

Alan Jenkins
Chief Executive
Electricity Networks Association