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Proposed amendment to the WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services

Invitation to provide your views

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1. Introduction

Purpose of this paper

- 1.1 This paper sets out our revised draft decision on the appropriate WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services. This paper also sets out proposed consequential amendments to the input methodologies applying to price-quality regulation as a result of the changes to the WACC percentile for information disclosure.

Input methodologies affected

- 1.2 The proposed input methodologies amendments apply to the following determinations:
- 1.2.1 *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 (**EDB IM Determination**);¹
 - 1.2.2 *Transpower Input Methodologies Determination* [2012] NZCC 17 (**Transpower IM Determination**);²
 - 1.2.3 *Gas Distribution Services Input Methodologies Determination 2012* [2012] NZCC 27 (**GDB IM Determination**);³ and
 - 1.2.4 *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28 (**GTB IM Determination**).⁴
- 1.3 The proposed amendments to each of these determinations are detailed in section two of this paper.

¹ For the most recent consolidated version of this determination, please refer to our website at: <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/electricity-distribution/>.

² For the most recent consolidated version of this determination, please refer to our website at: <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/transpower-input-methodologies/>.

³ For the most recent consolidated version of this determination, please refer to our website at: <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/gas-pipelines-2/>.

⁴ For the most recent consolidated version of this determination, please refer to our website at: <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/gas-pipelines-2/>.

These proposed amendments are part of our review of the WACC percentile for electricity lines and gas pipeline businesses

- 1.4 This paper sets out draft input methodologies in accordance with sections 52X and 52V(2) of the Commerce Act 1986. The draft input methodologies are part of our review of the appropriate WACC percentile for electricity lines and gas pipeline businesses regulated under Part 4 of the Commerce Act 1986. This paper should be read together with our final decision on the WACC percentile for price-quality regulation.⁵

We invite your views on this draft decision on the WACC percentile range for information disclosure for energy businesses

- 1.5 You are invited to provide your views on this draft decision.
- 1.5.1 Submissions are due by **5.00pm, 14 November 2014**.
- 1.5.2 Cross-submissions are due by **5.00pm, 21 November 2014**.
- 1.6 We expect to reach a final decision on the WACC percentile range for information disclosure for energy businesses by 12 December 2014.

⁵ Commerce Commission “Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services: Reasons paper” (30 October 2014).

2. Proposed amendments

Our previous draft decision was to reduce the range to the 33rd to 67th percentile

- 2.1 In our previous draft decision, we proposed to change the WACC range for information disclosure for energy businesses from the 25th–75th percentile to the 33rd–67th percentile on the basis that:⁶

Consistent with the reduction in the WACC percentile for price-quality path regulation, we consider that the WACC range for information disclosure for energy businesses should be from the 33rd to the 67th percentile.

- 2.2 The submissions we received on this topic raised questions about narrowing the WACC percentile range for information disclosure for energy businesses. In particular, Sapere noted that using the range of the 33rd to the 67th percentile would mean that there is only a 34% probability of obtaining an interval that does contain the true WACC.⁷

Our revised draft decision is to keep the current range but to also publish the 67th percentile

- 2.3 We have reached a revised draft decision on the WACC range for information disclosure for electricity lines businesses and gas pipeline businesses, which we invite further submissions on. Our revised draft decision on the appropriate WACC percentiles is:
- 2.3.1 to retain the 25th to 75th percentile range for information disclosure, which is determined and published annually; and
 - 2.3.2 in addition, to annually determine and publish 67th percentile estimates for information disclosure.
- 2.4 We have reached this revised draft decision because:
- 2.4.1 for energy businesses, disclosed return on investment (ROI) is generally compared against WACC ex post. The potential variation in disclosed ROIs ex post is likely to be higher than the uncertainty in estimating the WACC ex ante, given the various factors affecting actual supplier profitability performance. A narrower range of 33rd to 67th percentile might imply that

⁶ Commerce Commission “Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services” (22 July 2014), paragraph 62.

⁷ Sapere (on behalf of Vector) “Proposed amendment to the WACC percentile – Commerce Commission’s draft decision” (29 August 2014, pages 15-16.

we expect ex post ROIs to always fall within that range, which is not the case,⁸

- 2.4.2 therefore, the 25th to 75th percentile range remains useful in respect of assessing profitability ex post, as is the up-to-date 67th percentile (given that a 67th percentile will be used, ex ante, for the purpose of setting price-quality paths); and
- 2.4.3 the 67th percentile also provides a comparable reference point for regulated energy businesses that are not subject to price-quality regulation.

67th percentile to be used for the purposes of asset valuation

- 2.5 For information disclosure purposes, the 75th percentile estimate of WACC is currently used in the subpart of the IMs that deals with asset valuation. Specifically, the 75th percentile estimate of post-tax WACC is used to set a limit, for suppliers subject to price-quality regulation, on the cost of financing applicable under GAAP when determining the value of commissioned assets.⁹ Our revised draft decision, as per our previous draft decision, is to move from using the 75th to the 67th percentile for this purpose.
- 2.6 In addition to the proposed amendments to the input methodologies for information disclosure, we propose consequential amendments to certain provisions in the CPP parts (ie, Part 5) of the EDB IM Determination, GDB IM Determination and GTB IM Determination, which rely on the WACC published for information disclosure purposes. In Part 5 of each of those determinations, the 75th percentile estimate of post-tax WACC, as published each year for information disclosure purposes, is currently used for the purposes of calculating the forecast value of commissioned assets. Specifically, the 75th percentile estimate of post-tax WACC is used to set a limit, for regulated suppliers, on the cost of financing applicable under GAAP when determining the value of an asset forecast to be commissioned.¹⁰ Our revised draft

⁸ Publishing the 67th percentile means that interested persons will be able to compare disclosed ROIs for suppliers subject to price-quality regulation, over time, against the WACC used to set the relevant price-quality path, as well as against the current value of the 67th percentile WACC. Continuing to publish the 25th to 75th WACC percentile range as well recognises that the ex post ROI may differ from the WACC used to set the price-quality path for a number of reasons, including superior performance. Doing so provides a range against which the extent of any differences between the disclosed ROI and the 67th percentile WACC can be more readily identified.

⁹ See: clauses 2.2.11(2)(b)(i) and 2.2.11(3)(b) of the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26; clauses 2.2.7(2)(b) and 2.2.7(3)(b) of the *Transpower Input Methodologies Determination 2012* [2012] NZCC 17; clauses 2.2.11(2)(b) and 2.2.11(3)(b) of the *Gas Distribution Services Input Methodologies Determination 2012* [2012] NZCC 27; and clauses 2.2.11(2)(b) and 2.2.11(3)(b) of the *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28.

¹⁰ See: clause 5.3.11(3)(b) of the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26; clause 5.3.11(3)(b) of the *Gas Distribution Services Input Methodologies Determination*

decision, as per our previous draft decision, is to move from using the 75th to the 67th percentile for this purpose.

WACC percentile range for airports to be considered separately

- 2.7 As noted in our earlier draft decision,¹¹ we intend to consult on the appropriate WACC percentile range for airports, which only applies under information disclosure regulation, separately at a later date.

Proposed implementation of our revised draft decision

- 2.8 We propose that the timing for the changes to the WACC percentile range outlined above is aligned, to the extent possible, with the default and individual price-quality path resets for electricity lines services and gas pipeline services.
- 2.9 This means that the proposed WACC percentile range for information disclosure would apply for the first time:
- 2.9.1 for electricity distributors, to our WACC determination for the 2016 information disclosure year;¹²
 - 2.9.2 for Transpower, to our WACC determination for the 2016 information disclosure year;
 - 2.9.3 for gas pipeline businesses, to our WACC determinations for the 2018 information disclosure year.
- 2.10 This timing would be given effect by including in the amendment determination the relevant effective dates for the proposed amendments.
- 2.11 The proposed change to the IMs would also require minor, consequential amendments to the information disclosure determinations to implement.¹³ We

2012 [2012] NZCC 27; and clause 5.3.11(3)(b) of the *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28.

¹¹ Commerce Commission "Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services" (22 July 2014), paragraph 1.27-1.28.

¹² Orion is currently on a CPP, which will end on 31 March 2019. The WACC that applies to Orion's current CPP regulatory period is the 75th percentile estimate of WACC as determined in September 2012. Under the amendments proposed in this draft decision, the 67th percentile of WACC would be introduced for information disclosure purposes for Orion for the 2016 information disclosure year, as for all other electricity distribution businesses.

¹³ For example, to update the ROI schedules to also include a row for reporting against the 67th percentile and to include a definition for the 67th percentile in the schedule of definitions.

would intend to make those amendments as part of our programme of information disclosure amendments.¹⁴

Drafting of proposed amendments

- 2.12 The changes necessary to give effect to these proposed amendments are set out below (with proposed new text underlined).
- 2.13 The proposed drafting relates to the IM determinations as amended all subsequent amendments, including the *Electricity Lines Services and Gas Pipeline Services Input Methodologies Determination Amendment (WACC percentile for price-quality regulation) 2014*¹⁵ determined on 29 October 2014.

EDB IM Determination

- 2.14 We propose that the following amendments to the EDB IM Determination take effect immediately following notice in the Gazette. This means they will first apply to the WACC estimates we determine in April 2015 for the 2016 information disclosure year. This will align the introduction of the 67th percentile for information disclosure purposes with the 67th percentile taking effect for default price-quality regulation under the 2015 EDB reset.
- 2.15 In clause 1.1.4(2), replace the definition of “67th percentile estimate of WACC” with:
- 67th percentile estimate of WACC** means, estimate, made in accordance with, for the purpose of-
- (a) Part 2, clause 2.4.7(5)(b), of the 67th percentile for the post-tax mid-point estimate of WACC;
- (b) Part 4, clause 4.4.7(2), of the 67th percentile for the **mid-point estimate of WACC**; and
- (c) Part 5, clause 5.3.28, of the 67th percentile for the **mid-point estimate of WACC**;
- 2.16 In clause 1.1.4(2), delete the definition of “75th percentile estimate of WACC”.

¹⁴ See our recent consultation paper on information disclosure amendments programme for electricity distributors and gas pipeline businesses: Commerce Commission “Proposed amendments for 2015 to information disclosure determinations for electricity distribution and gas pipeline services: Consultation paper (22 October 2014), paragraphs 3.38 to 3.40, available at <http://www.comcom.govt.nz/amendments-to-information-disclosure-requirements-2015/>. Amendments to Transpower’s information disclosure requirements will be considered separately.

¹⁵ [2014] NZCC 27.

2.17 In clauses 2.2.11(2)(b)(i), 2.2.11(3)(b) and 5.3.11(3)(b), replace "75th percentile" with "67th percentile".

2.18 Replace clause 2.4.7 with:

2.4.7 Methodology for estimating the WACC range and the 67th percentile of the WACC

(1) The **Commission** will determine a WACC range for each **mid-point estimate of WACC-**

(a) for each **disclosure year**; and

(b) subject to clause 2.4.1(3), within 1 month of the start of the disclosure year in question.

(2) For the purpose of subclause (1), 'WACC range' means the values falling between the 25th percentile and 75th percentile inclusive of the **mid-point estimate of WACC**.

(3) For the purpose of subclause (2)-

(a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and

(b) the-

(i) 75th percentile must be determined in accordance with the formula-

mid-point estimate of WACC + 0.674 x standard error; and

(ii) 25th percentile must be determined in accordance with the formula-

mid-point estimate of WACC - 0.674 x standard error,

where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be.

(4) The **Commission** will determine a 67th percentile estimate of vanilla **WACC** and post-tax **WACC-**

(a) for each **disclosure year**; and

(b) within 1 month of the start of the disclosure year in question.

(5) For the purpose of subclause (4)-

- (a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and
- (b) the 67th percentile must be determined in accordance with the formula-

mid-point estimate of WACC + 0.440 x standard error,

where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be.

Transpower IM Determination

2.19 We propose that the following amendments to the Transpower IM Determination take effect immediately following notice in the Gazette. This means they will first apply to the WACC estimates we determine in July 2015 for the 2016 information disclosure year. This will align the introduction of the 67th percentile for information disclosure purposes with the 67th percentile taking effect for individual price-quality regulation under the 2015 Transpower IPP reset.

2.20 In clause 1.1.4(2), delete the definition of “75th percentile estimate of WACC”.

2.21 In clause 1.1.4(2), insert the following definition of “67th percentile estimate of WACC”:

“**67th percentile estimate of WACC** means, estimate, made in accordance with, for the purpose of-

(a) Part 2, clause 2.4.7(5)(b), of the 67th percentile for the post-tax **mid-point estimate of WACC**; and

(b) Part 3, clause 3.5.7(2), of the 67th percentile for the **mid-point estimate of WACC**;”.

2.22 In clauses 2.2.7(2)(b) and 2.2.7(3)(b), replace "75th percentile" with "67th percentile".

2.23 Replace clause 2.4.7 with:

“2.4.7 Methodology for estimating the WACC range and the 67th percentile of the WACC

(1) The **Commission** will determine a WACC range for each **mid-point estimate of WACC**-

(a) for each **disclosure year**; and

(b) subject to clause 2.4.1(3), within 1 month of the start of the disclosure year in question.

- (2) For the purpose of subclause (1), 'WACC range' means the values falling between the 25th percentile and 75th percentile inclusive of the **mid-point estimate of WACC**.
- (3) For the purpose of subclause (2)-
- (a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and
- (b) the
- (i) 75th percentile must be determined in accordance with the formula-
- mid-point estimate of WACC** + 0.674 x standard error; and
- (ii) 25th percentile must be determined in accordance with the formula-
- mid-point estimate of WACC** - 0.674 x standard error,
- where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be.
- (4) The **Commission** will determine a 67th percentile estimate of vanilla **WACC** and post-tax **WACC** -
- (a) for each **disclosure year**; and
- (b) within 1 month of the start of the disclosure year in question.
- (5) For the purpose of subclause (4)-
- (a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and
- (b) the 67th percentile must be determined in accordance with the formula-
- mid-point estimate of WACC** + 0.440 x standard error,
- where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be."

GDB IM Determination

- 2.24 We propose that the following amendments to the GDB IM Determination are timed so as to not take effect until we are due to determine WACC estimates for the 2018 information disclosure year. This will, to the extent possible, align the introduction of the 67th percentile for information disclosure purposes with the 67th percentile taking effect for default price-quality regulation under the 2017 GDB reset.
- 2.25 In clause 1.1.4(2), replace the definition of “67th percentile estimate of WACC” with:
- “**67th percentile estimate of WACC** means, estimate, made in accordance with, for the purpose of-
- (a) Part 2, clause 2.4.7(5)(b), of the 67th percentile for the post-tax **mid-point estimate of WACC**;
- (b) Part 4, clause 4.4.7(2), of the 67th percentile for the **mid-point estimate of WACC**; and
- (c) Part 5, clause 5.3.28, of the 67th percentile for the **mid-point estimate of WACC**.”.
- 2.26 In clause 1.1.4(2), delete the definition of “75th percentile estimate of WACC”.
- 2.27 In clauses 2.2.11(2)(b), 2.2.11(3)(b) and 5.3.11(3)(b), replace "75th percentile" with "67th percentile".
- 2.28 Replace clause 2.4.7 with:
- “2.4.7 Methodology for estimating the WACC range and the 67th percentile of the WACC
- (1) The **Commission** will determine a WACC range for each **mid-point estimate of WACC**-
- (a) for each **disclosure year**; and
- (b) subject to clause 2.4.1(3), within 1 month of the start of the disclosure year in question.
- (2) For the purpose of subclause (1), 'WACC range' means the values falling between the 25th percentile and 75th percentile inclusive of the **mid-point estimate of WACC**.
- (3) For the purpose of subclause (2)-
- (a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and
- (b) the-

- (i) 75th percentile must be determined in accordance with the formula-

mid-point estimate of WACC + 0.674 x standard error; and

- (ii) 25th percentile must be determined in accordance with the formula-

mid-point estimate of WACC - 0.674 x standard error,

where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be.

(4) The **Commission** will determine a 67th percentile estimate of vanilla **WACC** and post-tax **WACC** -

(a) for each **disclosure year**; and

(b) within 1 month of the start of the disclosure year in question.

(5) For the purpose of subclause (4)-

(a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and

(b) the 67th percentile must be determined in accordance with the formula-

mid-point estimate of WACC + 0.440 x standard error,

where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be."

GTB IM Determination

2.29 We propose that the following amendments to the GTB IM Determination are timed so as to not take effect until we are due to determine WACC estimates for the 2018 information disclosure year. This will, to the extent possible, align the introduction of the 67th percentile for information disclosure purposes with the 67th percentile taking effect for default price-quality regulation under the 2017 GTB reset.

2.30 In clause 1.1.4(2), replace the definition of "67th percentile estimate of WACC" with:

"67th percentile estimate of WACC means, estimate, made in accordance with, for the purpose of-

(a) Part 2, clause 2.4.7(5)(b), of the 67th percentile for the post-tax **mid-point estimate of WACC**;

- (b) Part 4, clause 4.4.7(2), of the 67th percentile for the **mid-point estimate of WACC**; and
- (c) Part 5, clause 5.3.24, of the 67th percentile for the **mid-point estimate of WACC**;

2.31 In clause 1.1.4(2), delete the definition of "75th percentile estimate of WACC".

2.32 In clauses 2.2.11(2)(b), 2.2.11(3)(b) and 5.3.11(3)(b), replace "75th percentile" with "67th percentile".

2.33 Replace clause 2.4.7 with:

"2.4.7 Methodology for estimating the WACC range and the 67th percentile of the WACC"

- (1) The **Commission** will determine a WACC range for each **mid-point estimate of WACC**-
 - (a) for each **disclosure year**; and
 - (b) subject to clause 2.4.1(3), within 1 month of the start of the disclosure year in question.
- (2) For the purpose of subclause (1), 'WACC range' means the values falling between the 25th percentile and 75th percentile inclusive of the **mid-point estimate of WACC**.
- (3) For the purpose of subclause (2)-
 - (a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and
 - (b) the-
 - (i) 75th percentile must be determined in accordance with the formula-
mid-point estimate of WACC + 0.674 x standard error; and
 - (ii) 25th percentile must be determined in accordance with the formula-
mid-point estimate of WACC - 0.674 x standard error,

where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be.

(4) The **Commission** will determine a 67th percentile estimate of vanilla **WACC** and post-tax **WACC** -

(a) for each **disclosure year**; and

(b) within 1 month of the start of the disclosure year in question.

(5) For the purpose of subclause (4)-

(a) the **mid-point estimate of WACC** must be treated as the 50th percentile; and

(b) the 67th percentile must be determined in accordance with the formula-

mid-point estimate of WACC + 0.440 x standard error,

where 'standard error' means the standard error of the relevant **mid-point estimate of WACC**, as determined in accordance with clause 2.4.6(2) or 2.4.6(3), as the case may be."

3. How you can provide your views and next steps

- 3.1 This chapter sets out how you can provide your views on the proposed amended input methodologies set out in this paper, and the next steps in our process.

Timeframe for providing your views

- 3.2 We welcome your views on the amendments proposed in this paper.

3.2.1 Submissions are due by **5.00pm, 14 November 2014**.

3.2.2 Cross-submissions are due by **5.00pm, 21 November 2014**.

Address for submissions

- 3.3 Submissions should be addressed to:

Brett Woods (Senior Analyst, Regulation Branch)
c/o regulation.branch@comcom.govt.nz

Format for submissions

- 3.4 We prefer submissions in both MS Word and PDF file formats.

- 3.5 Please include "Submission on Proposed WACC percentile range for information disclosure for electricity lines services and gas pipeline services, 30 October 2014" in the subject line of your email.

Requests for confidentiality

- 3.6 We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner, but we offer the following guidance.

3.6.1 If it is necessary to include confidential material in a submission, both confidential and public versions of the submission should be provided.

3.6.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

- 3.7 We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions and cross-submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Next steps in our process

- 3.8 We expect to make a final decision on the proposed amendments in this paper by 12 December 2014.