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21 March 2014

Brett Woods
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Regulation Branch
Commerce Commission
Wellington

Sent by email to: regulation.branch@comcom.govt.nz

Dear Brett,

Cross submission: 75th percentile WACC review

1. This cross-submission responds to selected submissions received by the Commerce Commission on its consultation paper *Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies* (Consultation paper), dated 20 February 2014.
2. We note that cross-submissions were not built into the Commission's process for this consultation. However, given the significance of the issue under discussion we consider it is important for the Commission to reach a view that is as informed as possible. We therefore trust that this cross-submission will be helpful and that it will be taken into account by the Commission when deciding whether, when and how to undertake a review of the cost of capital input methodology (WACC IM).
3. Accompanying this submission is a legal opinion from Russell McVeagh that reviews the legal opinion provided by Franks Ogilvie on behalf of the Major Electricity Users Group (MEUG).

Comments on MEUG's submission

4. MEUG asserts that:¹

"The High Court's emphatic validation of most of the cost of capital IM makes a full review ahead of schedule unnecessary"

"the High Court upheld all other relevant parts of the cost of capital IM and would have done so even if the midpoint WACC was used for price-quality paths."

¹ MEUG, *Views on whether to review or amend the cost of capital input methodologies*, 13 March 2014, pages 3 and 4

5. Vector submits that MEUG's assertions are without basis. The High Court rejected all appeals against the WACC IM and upheld the WACC IM as a whole. No evidence was placed before the Court to demonstrate, one way or the other, whether other elements of the IMs should change if the 75th percentile also changed and the Court did not consider this issue. It is simply not possible to know what the WACC IM would have looked like if the Commission had determined it in 2010 without the 75th percentile adjustment or what the High Court's view of that WACC IM would have been.
6. MEUG also asserted that:²
 - "there is reason to consider that the excess return prospects may be immaterial as a driver of necessary (efficient) investment, despite their very high costs for consumer. Other incentives or decision factors include, for example:
 - a) requirements to invest to maintain mandatory quality standards under price quality paths because failure to do so might impose a higher regulatory burden reducing returns to line owners;
 - b) the relative importance of volatility in unders and overs arising from chance, depending on the reset dates of regulatory periods and in particular, the risk-free rate prevailing at the time;
 - c) the assurance of keeping gains from efficiency (cost reductions) within regulatory periods;
 - d) other constraints on timing such as seasonal factors, planning, resource availability, coordination."
7. In relation to item (a) we note that investment solely to maintain quality standards over a regulatory period may be an insufficient incentive on its own to invest in any one year given that there is generally a lag between under-investment and a worsening of SAIDI and SAIFI. It would also be inappropriate for a regulator to rely on pecuniary penalties under a regulatory regime as a driver of investment without also providing positive incentives. Items (b) – (d) appear to relate more to the timing of investments and/or efficiency gains in relation to opex rather than whether there are sufficient incentives for the investments to be made in the first place, it is therefore not clear they are relevant.
8. Finally, MEUG argues that a report by Macquarie Private Wealth "considered it more likely than not that the Commission will cease to use the 75th percentile uplift" and cites this report as evidence that "the market will factor in the probability of a reversion to the midpoint".³ However, the Macquarie Private Wealth report was published on 7 February 2014 – the day the Commission made clear its intention to

² Ibid, page 2.

³ Ibid, page 3.

consider bringing forward the review of the 75th percentile adjustment. It therefore supports Vector's position that any uncertainty or weakened incentives are being created by the Commission's proposal to bring forward the WACC IM review, not by the judgement itself.

Comments on NZIER's report for MEUG

9. On behalf of MEUG, NZIER provided a report that made the following claims:⁴

"the weight of evidence supports regulatory WACC being set at estimated WACC (notionally the mid-point or 50th percentile)"; and

"the fact that regulated outputs are inputs to other sectors of the economy is a significant factor which should be taken into account in setting WACC IMs"

10. We note that NZIER's report is high-level and contains a number of unsupported assertions. While this is understandable given the timeframes available for this consultation process, the report falls short of the need for evidence not assertions, as emphasised by the High Court. The topics discussed in the NZIER report are also more appropriately addressed as part of any future review of the WACC IM rather than in the consultation on whether to review the WACC IM, which should be a process consultation only.

Comments on Contact Energy's submission

11. Contact Energy asserts that:⁵

"The Commission will be aware that a decision to reduce the weighted average cost of capital (WACC) percentile estimate to the mid-point could have significant impact in reducing the bills received by our customers."

12. Vector notes that it is not at all clear that any price reductions made by regulated suppliers will be passed on by retailers to their consumers – our recent experience is that it is not clear that retailers have passed on Vector's price reductions in full. While this issue is largely outside of the Commission's jurisdiction, and should not be determinative of whether or not to retain the 75th percentile adjustment, it does

⁴ NZIER, *WACC uplift: preliminary advice*, 13 March 2014, page 1.

⁵ Contact Energy, *Consultation on possible review or amendments of the cost of capital input methodologies*, 13 March 2014, page 1.

indicate that claims of direct consumer benefit from price reductions should be treated with caution.

Comments on Genesis Energy's submission

13. Finally, Vector agrees with Genesis Energy⁶ that:

"It is critical that any early review of the IMs is conducted in such a manner to provide a robust and fulsome result. We agree with the Commission that it is not possible to complete a full review of the IMs before November 2014. In fact, we consider that the indicative timetable stated in the consultation paper is too tight and risks providing a rushed analysis."

Contact details

14. If you would like to discuss this submission or have any further questions please contact me at 09 978 8340 or at allan.carvell@vector.co.nz.

Kind regards,



Allan Carvell
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⁶ Genesis Energy, *Should the Commerce Commission review or amend the cost of capital input methodologies*, 13 March 2014, page 2.