MAJOR ELECTRICITY USERS' GROUP

5th February 2016

Keston Ruxton
Manager, IM Review
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Keston

Submission on Cost of Capital Update Paper: 30 November 2015

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission paper "Input methodologies review – Update paper on the cost of capital topic" dated 30th November 2015 (the "Update paper"). Other relevant materials are advice from Dr Martin Lally to the Commission, the terms of reference for advice sought by the Commission from Dr Lally, and a report for the Commission by Cambridge Economic Policy Associates[1].

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.

Scope of this submission

3. The Update paper requires that submissions should provide additional evidence[2]. The Update paper also traverses some new ground or seeks views on next steps.

4. This submission has three sections covering Black's Simple Discount Rule (BSDR) as a potential cross-check on WACC, split cost of capital, and WACC percentile. We think these are likely to be of most material value to consumers. For this consultation round MEUG makes no comment on the other four topics listed in paragraph 1.14 of the Update paper[3] or other issues raised by the High Court in paragraph 4.2. An absence of comment on those other matters is not an indication we are supportive or are indifferent; rather we will wait for the next consultation round(s).

5. MEUG looks forward to the Commission's proposed work to reconsider aspects of the estimation process for cost of capital parameter estimates and related standard errors. Estimates cannot rely entirely on quantitative analysis given potential sampling limitations. For example when estimating asset beta. Setting parameter values in isolation without

[1] All materials at http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/
[2] Update paper paragraphs 1.2 to 1.7.
[3] Those four topics are possible indexation and trailing averages for the risk-free rate and or debt-premium, treatment of longer term debt and WACC for CPP applications.

considering the interlinkages across all the cost of capital IMs was identified in the Update paper as an approach to be avoided (paragraph 3.14):

> "… we wish to make it clear that we would ensure any change made to the cost of capital IMs would only be introduced after its impact on the estimation of the WACC as a whole …"

6. MEUG would extend that view to ensure WACC parameter values are not set in isolation without considering interlinkages across all IMs and consistency across all regulated utilities. In other words estimating WACC and values for WACC parameters needs to be undertaken when considering the overall package of all Part 4 IMs and how those treat risks, rewards, incentives and penalties.

Black's Simple Discount Rule

7. MEUG welcomes the Commission being[4] "interested in further exploring the potential" for using BSDR as a cross-check on WACC estimates using the Simplified Brennan-Lally Capital Asset Pricing Model (SBL-CAPM).

8. To find an appropriate benchmark security MEUG suggest the Commerce Commission seek advice from Dr Claudio F. Loderer et al, the authors of the August 2008 article on BSDR MEUG has previously submitted[5]. That analysis related to capital markets in the US, Australia, Canada, France, Germany, Hong Kong, Japan, Spain, Switzerland and the UK[6]. It would be appropriate for those authors to extend and update that analysis and include New Zealand. MEUG suggest this would be a worthwhile piece of external advice to commission[7].

9. To determine the distribution of expected cash-flows MEUG have previously submitted a report by Ireland, Wallace & Associates that set out a[8]:

> "… replication of the example used by Loderer et al. and a version adapted to illustrate a framework referencing to the recent Transpower individual price-quality path determination."

10. If engaging Loderer et al. for advice on an appropriate benchmark security as proposed in paragraph 8 above then it would be appropriate to seek their review of applying BSDR to all regulated activities including Transpower, electricity distributors, regulated gas pipeline services and airport services, etc.

11. One final separate comment on BSDR. The terms of reference for expert advice on cost of capital topics from Dr Martin Lally in paragraph 12 b) asks:

> "What role if any can BSDR add to the consideration of the asset beta in topic 2a?"

12. It would be more useful if a more open question were asked as follows:

> "What role if any can BSDR add to the consideration of WACC in topic 2a?"

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[4] Update paper, paragraph 3.83.
[5] Claudio F. Loderer et al, Black's Simple Discounting Rule, August 2008, last revised 2013, listed in submissions on Commerce Commission web site at URL http://www.comcom.govt.nz/dmsdocument/13454
[6] Ibid section D, p26.
[7] The WACC IMs Update paper notes seeking external advice is an option, refer paragraph 3.84.
[8] Ireland, Wallace & Associates Limited, Input Methodology Review "Black's Simple Discount Rule" a cross check on the IM Cost of Capital for Major Electricity Users' Group, 19th August 2015, paragraph 1.1 (b), listed in submissions on Commerce Commission web site at URL http://www.comcom.govt.nz/dmsdocument/13628

Split cost of capital

13. The Update paper surveys the history of overseas regulators consideration of split cost of capital on pages 40 to 44 and concludes by setting out the Commission's position on pages 45 to 47.

14. The Update paper correctly interprets MEUG's suggested split cost of capital as referring to different values of WACC rather than the approach proposed by Dr Dieter Helm whereby regulated services receive cost of debt only[9].

15. The Update paper in summary concludes a split cost of capital potentially could be useful but there are significant implementation problems. The Commission in effect has decided the costs of considering how to overcome those implementation problems are likely to outweigh possible benefits; hence no further work is proposed. MEUG has not undertaken an analysis to test that conclusion. Nevertheless we think there is merit in some cases of using a notional split cost of capital counterfactual to test estimates of aggregate WACC. We explain this approach in the next two paragraphs.

16. Split cost of capital has been seen by MEUG as a possible option to separate a lower WACC to apply to existing sunk assets versus a higher WACC with an incentive component to apply to new investment. That is just one example of having differentiated WACC for different line services that have different risk, reward, incentive and penalty profiles. Line companies already separate different services, such as dedicated connection services, with be-spoke contract terms including WACC. While not straight forward to implement multiple WACC for different line services at least recognising this is a factor when deciding a WACC will address problems with assuming a single aggregate WACC is appropriate.

17. The idea that line monopolies should have a multiplicity of WACC given a range of services with different risk, reward, incentive and penalty profiles could be helpful when considering the impact of evolving technologies. For example we don't want a global WACC with a large incentive component that will drive new investment decisions when those might be stranded in the future. In that scenario incentives for disinvestment are needed and WACC adjusted accordingly. Hence retaining even as a notional counterfactual the use of a split cost of capital may give insights into estimating WACC.

WACC percentile

18. Referring to the 2014 amendment to the WACC percentile the update paper states[10]:

> "Since the amendment we have not received any new evidence on this area and we do not intend to commission or do any further substantive analysis as part of this IM review on the percentile applicable to regulated energy services."

19. The last opportunity for formal submissions on WACC percentile along with comments on problem definition closed 25th August 2015. At that time there was no new evidence on WACC percentile. Since that date there have been two market transactions where the Enterprise Value to the Regulated Asset Base multiples (EV to RAB multiple) imply the market view of WACC is less than the regulated WACC. Two documents are attached to this submission as evidence:

- Craigs Investment Partners report, 9th November 2015 estimating an EV to RAB multiple of 1.33 for the sale and purchase of Vector's gas transmission and gas distribution outside of Auckland businesses; and

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[9] Update paper, paragraph 4.35.
[10] Ibid, paragraph 4.10.

- First NZ Capital report, Spark Infrastructure Group, 26th November 2015 estimating an EV to RAB multiple of 1.6 for the transaction related to Transgrid in Australia.

20. The former is relevant because the transaction is after the 2014 WACC percentile amendment. MEUG is not aware of any evidence in recent times of independent broker estimates of EV to RAB multiples below one. The two attached reports continue that trend reinforcing a view that regulators systematically over-estimate WACC for regulated energy line services including the most recent 2014 WACC percentile amendment in New Zealand.

Yours sincerely

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