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Input Methodologies Review

Overview of decisions – analyst briefing

20 December 2016

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Overview of presentation

Today we released our decisions on the IM review

This presentation covers:

- Framework
- Key changes since June 2016 draft decisions
- Topics: emerging technology and cost of capital
- Key decisions by sector
- Papers published today
- Next steps for outstanding areas of the review

The IMs and the Part 4 regime

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IMs are upfront rules, processes and requirements of Part 4 regulation. Their purpose is to promote certainty.

- The first IMs were determined in December 2010
- We must review IMs no later than 7 years from setting
- We commenced the review on 10 June 2015

We have today reached decisions on all IMs except:

  - CPP information requirements for gas
  - Related party transactions provisions
  - Transpower IRIS
- Excludes Transpower capex IM (set later in 2012)

The IMs and the Part 4 regime

When do IM decisions influence pricing?

Price-quality path resets by the Commission

New CPP proposals	2017
Gas pipeline businesses	2017
Electricity distribution businesses and Transpower	2020

Price-setting events by airports

Auckland and Christchurch	2017
Wellington	2019

Framework

We reviewed all IMs and found most do not need to change

We have made a small number of substantive changes and some refinements, which:

- Better promote the Part 4 purpose (long-term benefit of consumers)
- Enhance the certainty provided by the IMs
- Reduce compliance costs and complexity

The most significant changes relate to cost of capital, emerging technology and form of control

Key changes since draft decisions

December 2016 final decision	June 2016 draft decision
ACAM removed as a stand-alone option from cost allocation IM for EDBs and GPBs	Keep ACAM but tighten the threshold for using it
Adopted asset betas of: • 0.35 for EDBs and Transpower • 0.40 for GPBs • 0.60 for airports	Proposed asset betas of: • 0.34 for EDBs and Transpower • 0.34 for GPBs • 0.58 for airports
Moved to an historical averaging approach for the debt premium	Retain a prevailing rate approach

Emerging technology

Improvements in technology are likely to drive significant change but major changes to IMs not needed at this time

- Stakeholders had a variety of views on likely developments, opportunities and challenges for EDBs
- Two key concerns were raised:
  - EDBs competing in unregulated energy-related markets (eg, battery storage, PV)
  - The risk that EDBs will not be able to recover network investment

Emerging technology

EDBs competing in unregulated energy-related markets (eg, battery storage, PV)

- Cost allocation IM allows EDBs and GPBs to invest in other regulated and unregulated services (achieving economies of scope)
- No decisive evidence that large scale changes are needed to better promote long-term benefit of consumers of the regulated service provided that costs are allocated correctly
- Potential trade-off exists between integration & competition; economies of scope & leveraging market power
- Part 4 is not the instrument to alter industry structure - MBIE is leading cross-agency work on the need for further constraints

Emerging technology

We have changed the cost allocation IM to better ensure consumers of regulated businesses benefit from economies of scope

- We have removed the avoidable cost allocation methodology (ACAM) as a stand-alone option from the cost allocation IM for EDBs and GPBs

Emerging technology

Evidence suggests electricity distributors should be able to recover capital investment in short to medium term

But increased uncertainty over longer term

- Risk of partial capital recovery may have increased since 2010
- As a precautionary measure, we will allow EDBs to recover the cost of assets more quickly (ie, shorten asset lives)
- Reduction in average remaining asset lives of up to 15% on average
- We have retained RAB indexation for EDBs

Cost of capital

Cost of capital IM remains broadly fit for purpose

We have:

- updated our estimates of beta and leverage to reflect more up-to-date information
- re-examined the case for a trailing average cost of debt in response to the substantive stakeholder submissions
- examined a proposal by Major Electricity Users' Group (MEUG) for a cross-check with the Black's Simple Discounting Rule (BSDR)
- examined the issues raised by the High Court

Cost of capital – key decisions

Key changes for asset beta for EDBs, Transpower and airports

- 0.35 for EDBs and Transpower
- 0.60 for airports

Small uplift (relative to electricity) for asset beta for gas

- Our draft decision proposed removing the 0.1 uplift to the asset beta for gas
- Following evidence presented in submissions, we have decided to apply a small uplift of 0.05
- Asset beta for gas therefore 0.4

Cost of capital – key decisions

We have moved to an historical averaging approach for calculating the debt premium

- We will continue to estimate the risk-free rate using the prevailing rate, but will use a three-month determination window
- The debt premium will be estimated using a five-year historical average

Cost of capital – other decisions

We have made other refinements to the cost of capital IM:

- Reduced the allowance for debt issuance costs from 0.35% to 0.20%
- Removed the separate WACC for CPPs
- Simplified the TCSD
- Amended the estimates of leverage slightly based on the leverage for comparable companies
- Updated the WACC standard error
- We will publish a mid-point WACC and standard error estimate for airports

Cost of capital – impact

	Previous IMs WACC (as at 1 April)	New IMs WACC (as at 1 April)
EDBs & Transpower (Post-tax 67th)	5.23%	5.18%
GPBs (Post-tax 67th)	6.00%	5.56%
Airports (Post-tax 50th)	6.14%	6.15%

* The risk-free rate and debt premium have been held constant for this comparison.

Key decisions – EDBs

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Moved from a weighted average price cap (WAPC) to a ‘pure’ revenue cap with revenue wash ups

This will remove:

- Quantity forecasting risk, which may create disincentives to efficient expenditure
- Impediments to adopting efficient pricing caused by the compliance requirements of a WAPC
- Potential disincentives on EDBs to pursue energy efficiency and demand-side management initiatives

Key decisions – EDBs

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We have reduce complexity and compliance costs of CPPs to improve effectiveness

- Removed the separate WACC for CPPs – the DPP WACC will continue to apply
- Replaced the quality-only CPP with a quality reopener in the DPP
- Greater flexibility in CPP information & verifier requirements
- Better alignment of information requirements for a CPP with information already disclosed under ID
- Clarified expectations around consumer consultation
- Clarified the role and purpose of the verifier

Key decisions – Transpower

We have not made significant changes to the IMs for Transpower

- We have decided not to introduce the proposed mechanism to protect Transpower and its consumers from inflation risk (costs outweigh benefits)
- Draft decision on Transpower IRIS due Q1 2017, final decision due Q2 2017

Key decisions – gas pipelines

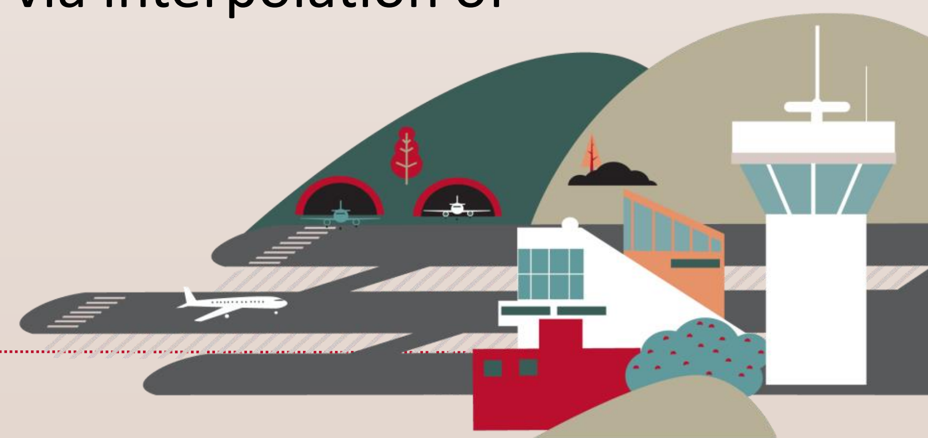
Made some refinements for gas pipelines

- Changed from ‘lagged’ revenue cap to ‘pure’ revenue cap with revenue wash ups for gas transmission
- Retained weighted average price cap for gas distribution
- Accelerated depreciation option does not apply to GPBs
- Some improvements to CPPs, eg, verifier requirements
- Draft decision on CPP information requirements due Q3 2017, final due Q4 2017
- Draft decision on DPP reset due February 2017

Key decisions – airports

We now require that airports disclose target profitability when setting prices

- Will help stakeholders better understand airports' pricing
- Airports to provide information so stakeholders can assess whether target returns are acceptable
- Greater flexibility in how airports disclose information
- 2010 regulatory land values to be set via interpolation of previously disclosed values



Key decisions – airports

We will publish a mid-point WACC and standard error estimate rather than a WACC range

- Airports must explain and provide evidence in disclosures why:
  - their target return differs from their WACC estimate
  - their WACC estimate differs from our WACC estimate
- Provides flexibility to take into account different contextual factors including risk of different projects

Summary

IMs held up well on review – we have made targeted changes in light of experience and changing environment

- We retained overall WACC approach with some changes to reflect new evidence
- Emerging technology – accelerated depreciation mitigates stranding risk, and cost allocation change will better ensure consumers of regulated services share in benefits from economies of scope
- Form of control – a revenue cap for EDBs and GTBs provides more flexibility to restructure prices and reduces forecast risk
- CPP rules are now more cost-effective and workable

Papers published today

- Overarching papers:
  - Summary paper
  - Introduction and process paper
  - Framework for the IM review
- Topic papers:
  - Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower
  - Topic paper 2 – CPP requirements
  - Topic paper 3 – The future impact of emerging technologies in the energy sector
  - Topic paper 4 – Cost of capital issues
  - Topic paper 5 – Airports profitability assessment
  - Topic paper 6 – WACC percentile for airports
- Report on the IM review
- Amendments determinations

Thank you

We are grateful to all those that have engaged in the IM review process

- Want to maintain regular and constructive interactions
- In particular, we will continue to engage with stakeholders on how the sector is developing to ensure we are ready to make any changes that may be required to IMs in the future

Next steps for outstanding areas

Step	Date
Related party transactions – Emerging views paper	February 2017
Transpower IRIS – Draft decision	Q1 2017
Related party transactions – Draft decision	Q2 2017
Transpower IRIS – Final decision	Q2 2017
CPP information requirements for gas pipeline businesses – Draft decision	Q3 2017
Related party transactions – Final decision	Q4 2017
CPP information requirements for gas pipeline businesses – Final decision	Q4 2017

Questions

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Contact us

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