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Further Submission from BARNZ on cost of capital input methodology

BARNZ thanks the Commission for providing interested parties with the opportunity to respond to the report the Commission requested from Professor Dobbs, the further information relevant to the RAB multiples analysis as well as the material raised in MEUG's cross-submission.

BARNZ has requested Dr John Small of Covec to review the report from Professor Dobbs as well as the NZIER reports provided on behalf of MEUG. The report from Covec is attached. In essence, Covec considers:

- The NZIER analysis drawing on recent reliability data disclosed by electricity distribution businesses is particularly relevant because it provides real data as to whether a higher WACC allowance will induce more investment and result in consumers gaining service quality benefits. NZIER's analysis of the reliability data shows that most of the unreliability of distribution networks is not readily fixed by extra investment, but rather is related to operating costs, therefore the justification for allowing an uplift to the cost of capital is under-mined.
- The paper provided by Professor Dobbs illuminates the fact that he designed his model to address the issue of investment in new services, not ongoing investment in reliability, renewal or capacity increases in existing networks.
- Professor Dobb's comments on consumer surplus not being given a greater weight than firm profits reflects the fact that it is not in the long term interests of consumers to have the sunk nature of existing networks exploited. This is consistent with Covec's previous submissions that the long-term qualifier in s52A protects against a zero rate of return. BARNZ notes this is also why the Commission allowed specialised assets to be valued at their most recent regulatory valuation rather than their opportunity cost, which would in some cases have equated to scrap value.
- The Commission's approach to its cost of capital input methodology, where the costs of finance elements of the WACC are reviewed periodically, differs from the Dobbs model which assumes the WACC is not indexed in any way. The periodic revision of the cost of finance element in the Commission's input methodologies reduces the case for an uplift above the best estimate of a normal return.

- The key insight provided by Professor Dobbs is his analysis of the issues relating to the maximum consumer willingness-to-pay. Professor Dobbs has highlighted that Frontier's approach does not pass basic sanity checks and significantly exaggerates the potential loss of welfare that would arise if investment does not occur, and consequentially exaggerates the extent of uplift predicted by the model.

BARNZ specifically wishes to comment on the Franks & Ogilvie advice provided on behalf of MEUG, which the Commission is similarly allowing interested parties to make submissions on.

Franks & Ogilvie summarise their advice as follows in paragraph 2 of their letter to MEUG:

a) The purpose statement in s52A requires the Commission to use a consumer welfare standard when making determinations under Part 4. The Commission would err in law were it to apply a total welfare standard, as it would fail to take proper account of wealth transfers between suppliers and users of the regulated services.

b) The Commission cannot rely on the promotion of incentives to invest to justify setting a regulatory WACC above the best estimate of a normal return, as that would not be consistent with outcomes produced in competitive markets and would be contrary to the purpose of Part 4.

c) If that opinion is wrong, and it is permissible for the Commission to promote a permanent or indefinite extraction of excess profit with a view to incentivising investment, it must still operate within the legislative parameters. This means
    i. It needs first to conduct a disciplined assessment of the effects of assured excess returns on innovation …
    ii. It must first find that there is a real and not theoretical asymmetry, which needs detailed real world examination of the scale of investment …
    iii. It must find that supplier investment behaviour is likely to be affected in the intended way by the incentive; and
    iv. It must find that the incentive is the best way to produce the desired outcome, having regard to the range of regulatory tools available, and their intended and unintended costs.

BARNZ supports the analysis and reasoning of Franks & Ogilvie. We provide comment below on each of these three aspects of Franks & Ogilvie's advice to MEUG.

Section 52A mandates a consumer welfare standard

BARNZ agrees with Franks & Ogilvie that the purpose statement in s52A requires the Commission to use a consumer welfare standard when making determinations under Part 4. As we set out in our 29 August 2014 submission to the Commission, Part 4 is (and was intended by Parliament to be) consumer welfare focused:

- The Explanatory Note accompanying the Commerce Bill as it was introduced to Parliament stated that the option of a purpose statement focusing only on improving efficiency upfront, with the implicit expectation that over time consumers will benefit, was *'not considered appropriate and [was] discarded'.*

- The Select Committee rejected submissions made by regulated suppliers that investment should be the primary objective in the purpose statement.

- The High Court in the merits review proceedings confirmed that the s1A solely efficiency based purpose statement did not apply to Part 4, noting that it was *'not apposite as a framework for those parts of the Act where the purpose of regulatory intervention is to counteract the absence of competition'* (refer paras 660 – 662) and instead (at para 680):

  > *…the option chosen for the purpose statement was one that explicitly stated that the objective of regulation was to improve efficiency and to protect consumers from excessive prices… That included both efficiency and distributional objectives, to provide for an appropriate balance between the protection of consumers and that of producers and investors.*

The discussion of the legislative history of s52A by the High Court at paragraphs 660 to 747 of its decision is particularly relevant, and was discussed previously by BARNZ in its original submission.

The s52A purpose statement in effect creates a consumer welfare focused 'micro-climate' for Part 4 within the wider, solely efficiency focused, climate of the rest of the Commerce Act.

An approach which only considers the efficiency criterion is outside the scope of s52A, just as an approach which only considers distributional outcomes would be outside s52A. Rather, as noted above in the passage quoted from the High Court merits review decision, there must be a balance between protecting consumers and investors, between efficiency and distributional outcomes. We agree with Franks & Ogilvie's advice to MEUG that it is the consumer welfare standard which enables these interests to be balanced. The consumer welfare standard, which the Commission defines as *'maximising benefits to consumers from both an efficiency and distributional standpoint'*, strives to maximise both outcomes – rather than inappropriately only focusing on one or the other.

We agree with the point made by Franks & Ogilvie that the decision to restrict the reference to consumers in s52A to *'consumers in markets referred to in section 52'* further points to the legislative intention of Part 4 being to move away from the total welfare approach, which is otherwise applicable to decisions made under the Commerce Act, which would have examined efficiency generally as opposed to focusing on consumers immediately involved in markets with little or no competition.

The WACC estimate must be one consistent with outcomes produced in competitive markets

BARNZ agrees with Franks & Ogilvie's advice to MEUG that the Commission cannot rely on the promotion of incentives to invest to justify setting a regulatory WACC above the best estimate of a normal return, as that would not be consistent with outcomes produced in competitive markets and contrary to the purpose of Part 4.

It is axiomatic that the incentives to innovate and invest referred to in paragraph (a) of the purpose statement must be incentives that are consistent with competitive markets.

This rather obvious truth was also recognised by the High Court in its merits review decision when it described the incentives to innovate and invest being referred to by the purpose statement as *'ones that are consistent with those provided by workably competitive markets'* (para 686).

We therefore agree with Franks & Ogilvie that setting an input methodology allowing returns to be targeted above those expected in competitive markets would be to act outside of the ambit of Part 4. Long term excess returns are not a feature of competitive markets. In competitive markets any sustained (or indeed even short-term) returns above a normal level will attract new entrants to the market (or expansion by existing suppliers) which will soon result in those above-normal profits being competed away.

The Commission's mid-point WACC represents the best estimate of a normal return. It was confirmed by the High Court in the merits review decision as being free of any upwards or downwards bias. As such, the mid-point represents the best estimate of the return consistent with outcomes in competitive markets and should be more than sufficient to incentivise innovation and investment.

There would need to be very clear and incontrovertible proof of tangible and material long-term benefits for consumers before that best estimate of a normal return in a competitive market can be moved away from.

Any above normal return must be causatively linked to increasing the long-term benefit of consumers

Franks & Ogilvie's third branch of advice to MEUG is that, if it is permissible for the Commission to promote a permanent or indefinite extraction of excess profit with a view to incentivising investment, then this decision must still be made within and reflect the legislative parameters. Franks & Ogilvie describe this as meaning that the Commission must:

- Conduct a disciplined assessment of the effects of assured excess returns on innovation …
- Find that there is a real and not theoretical asymmetry, which needs detailed real world examination of the scale of investment …
- Find that supplier investment behaviour is likely to be affected in the intended way by the incentive; and
- Find that the incentive is the best way to produce the desired outcome, having regard to the range of regulatory tools available, and their intended and unintended costs.

BARNZ agrees. We would characterise these pre-conditions identified by MEUG under the principle that there must be evidential proof of tangible long-term benefits to consumers before allowing an uplifted WACC percentile above the best estimate of a normal return.

When determining the WACC percentile input methodology, the starting point must be the best estimate of a normal return. That can only be departed from if there is clear evidence that allowing a higher return is in the long-term benefit of consumers through providing incentives to innovate and invest that could not be achieved to the same extent by other means.

The Commission should not allow such an uplift without proof that greater returns on the existing RAB are necessary in order to incentivise <u>new investment</u>. However, as the High Court noted in its merit review decision *'applying the 75th percentile estimate to the initial RAB is unlikely to be necessary to promote incentives to invest and innovate. Future investment choices by suppliers must rationally be influenced by expected earnings on those future investments, not by earnings on past investments'.* (para 1479)

The Commission should require tangible evidence of likely under-investment and of consequential costs to consumers which would outweigh the additional charges consumers would have to pay.

The Commission should not allow such an uplift without proof that greater returns on the existing RAB are necessary in order to incentivise <u>innovation</u>. However, as the High Court noted in its merit review decision*…it is far from obvious that higher than normal expected returns would stimulate greater efficiency of any kind. On the contrary, they would render excess profits likely, even if less effort were made by suppliers to generate efficiencies than in a workably competitive market. … necessity, not plenty, is the mother of invention.* (para 1473 – 1474)

Moreover, the Commission should not allow an uplifted WACC percentile above the best estimate of a normal return unless it is e sure that doing so is the most appropriate way to incentivise investment and innovation, as opposed to other regulatory tools. We agree with Franks & Ogilvie's endorsement of the point we made in our 29 August submission, that the creation of certainty for regulated suppliers and consumers through the specification of input methodologies, which must be used when making regulatory decisions under Part 4, was the primary mechanism intended by the law drafters of Part 4 to promote incentives to innovate and invest.

That of course does not mean that the input methodologies cannot be varied. Very clear mechanisms exist within the Act permitting the review and amendment of the input methodologies. But it does mean that the knowledge that the Commission (or any decision maker under Part 4) must apply the input methodologies in existence at the time a regulatory decision is made is a key means by which incentives to innovate and invest were intended to be strengthened.

The High Court in its merits review decision observed that *'the certainty to be provided over time by the new Part 4 is central to the promotion of appropriate incentives to invest'* (para 691). It did not consider new asset valuations were necessary to incentivise investment. Similarly, it is difficult to see why allowing a return above the best estimate of a normal return is necessary to incentivise investment.

As the High Court stated *'…the expectation of earning (only) a normal return on new investment ought to be an attractive proposition for a regulated supplier'.* (para 1472)

BARNZ, likes Franks & Ogilvie, has difficulty in seeing how it would be in the long-term benefit of consumers or consistent with outcomes in competitive markets to allow regulated suppliers to expect to earn a return greater than the best estimate of a normal return on an indefinite basis going forward when a normal return should be sufficient to provide appropriate incentives to invest.

We urge the Commission to ensure that it only moves away from its best estimate of a normal return if it has clear and tangible proof that this is both necessary for the long-term benefit of consumers in the various regulated markets and will result in tangible benefits for those consumers (as opposed to benefits accruing to the regulated suppliers in the form of excess profits).

BARNZ notes that Professor Dobbs makes this same point several times in his advice to the Commission when he notes that he thinks *'it is important to consider carefully what the likely impact of the choice of allowed rate of return (AROR) is likely to have; after all, if the choice of AROR is unlikely to affect the pace of new investment, there is little point in offering a higher rate'* (para 14). The work undertaken by NZIER for MEUG analysing the reliability and outage data disclosed by electricity lines businesses is particularly relevant to this question. NZIER's work showed that most interruptions were attributable to, and resolved by, operating expenditure, not capital expenditure.

Professor Dobbs returns to this concern again later in his paper stating that if firms do not respond to incentives *'then any uplift in AROR is simply a windfall benefit to them and a loss to consumers'.* (para 36)

BARNZ agrees, and further observes that, in that circumstance, any uplift to the WACC above the best estimate of a normal return would be outside the bounds of s52A and thus impermissible.

Yours sincerely

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