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**Amendments to the WACC percentile range for information disclosure
regulation for electricity lines services and gas pipeline services**

Reasons Paper

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1. Introduction

Purpose of this paper

- 1.1 This paper sets out our decisions on the WACC percentiles for information disclosure regulation for electricity lines services and gas pipeline services, and explains the reasons supporting this. We also set out the consequential amendments to the input methodologies that apply to price-quality regulation.

Input methodologies affected

- 1.2 The input methodology 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 amendments to these determinations are detailed in section two of this paper.
- 1.4 The amendments in this paper were undertaken in accordance with sections 52X and 52V(2) of the Commerce Act 1986. They are part of our review of the appropriate WACC percentile for regulated electricity lines and gas pipeline businesses. This paper should be read together with our final decision on the WACC percentile for price-quality regulation.⁵

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/>.

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. Our final amendments

Our decision is to annually publish the 25th to 75th WACC range and the 67th percentile

- 2.1 Our decision is not to amend the 25th to 75th percentile range for information disclosure for electricity lines services and gas pipeline services.⁶ These percentile estimates of WACC will continue to be determined and published annually, along with the mid-point estimate (which is also currently published annually). In addition, we will annually determine and publish 67th percentile estimates so that these are available to ourselves and other interested persons to be used in analysing the performance of suppliers. All estimates will be published on both a vanilla and post-tax basis.
- 2.2 Our July 2014 draft decision proposed to change the WACC range for information disclosure for energy businesses from the 25th–75th percentile to the 33rd–67th percentile. The reason for that draft decision was that narrowing the percentile range was consistent with our draft decision to reduce the WACC percentile used for price-quality regulation from the 75th percentile to the 67th percentile.⁷
- 2.3 Submissions received on this topic raised questions about narrowing the WACC percentile range. In particular, Sapere noted that using the range of the 33rd to the 67th percentile would mean that there is only a 34% probability that our range contains the true WACC.⁸
- 2.4 In October 2014, we published our final decision to reduce the WACC percentile used for price-quality regulation from the 75th percentile to the 67th percentile.⁹ We also published a revised draft decision on the WACC percentiles for information disclosure for energy businesses, and proposed retaining the current percentile range.¹⁰ We proposed this because we considered the 25th to 75th percentile range to be useful for assessing profitability, ex post.
- 2.5 In response, all submissions (which were all from suppliers) on our revised draft decision agreed that it was more appropriate to retain the 25th to 75th percentile range than to adopt a narrower range. Transpower, supported the decision to reject adopting a narrower WACC percentile range, but questioned whether publishing a

⁶ We will consult on an appropriate WACC percentile range for airports separately.

⁷ Commerce Commission “Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services” (22 July 2014), paragraph 62.

⁸ Sapere (on behalf of Vector) “Proposed amendment to the WACC percentile – Commerce Commission’s draft decision” (29 August 2014, pages 15-16).

⁹ Commerce Commission “Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services: Reasons paper” (30 October 2014).

¹⁰ Commerce Commission “Proposed amendment to the WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services” (30 October 2014), paragraph 2.3.

WACC range would actually help make sufficient information available to interested parties for assessing whether the Purpose of Part 4 was being met. Transpower suggested that if a WACC range was used, a more logical range for ID purposes, would be the 50th to 67th, or the 60th to 67th which reflects that the Commission considers that the appropriate WACC for price control purposes is within this range.¹¹

- 2.6 Our revised draft decision also proposed annually publishing 67th percentile estimates of the WACC. All four submissions, and Transpower’s cross-submission, disagreed with this approach. The main reasons for disagreeing with 67th percentile estimates being published were that the 67th percentile is not a meaningful reference point, and that it may be confusing for people to know which is the most relevant benchmark for annual ROI disclosures.¹² ENA also submitted that the 67th has ‘no necessary relevance’ to exempt EDBs, and that the most relevant benchmark for annual ROI disclosures for non-exempt EDBs was the WACC set at the start of the 5-year regulatory period, and used to set the price cap. ENA also submitted that it is not necessary to annually publish mid-point WACC estimates.¹³
- 2.7 NZ Airports questioned whether there would be any value publishing the 67th percentile estimate for energy businesses, given the WACC range will also be published. NZ Airports also argued that publishing the 67th percentile represents a level of precision that is not required or appropriate for information disclosure.¹⁴
- 2.8 In responding to submissions, we note that:
- 2.8.1 The WACC cannot be observed and must be estimated. The WACC range reflects and illustrates this uncertainty.
- 2.8.2 The ROI disclosed by suppliers is affected by a range of factors including some which are outside the suppliers’ control. Analysis and interpretation is required to properly compare the ROI with estimates of WACC.

¹¹ Transpower cross submission, “WACC percentile range for information disclosure”, 21 November 2014, p.3.

¹² For example, ENA submission, “Consultation on WACC percentile range for information disclosure regulation”, 14 November 2014, p.3; and NZ Airports submission, “Proposed amendments to the WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services”, 14 November 2014, pp 4-5; Powerco submission, “Proposed amendments to WACC percentile range for information disclosure”, 14 November 2014; Transpower cross submission, “WACC percentile range for information disclosure”, 21 November 2014, p.1.

¹³ ENA submission, “Consultation on WACC percentile range for information disclosure regulation”, 14 November 2014, pp.2-3.

¹⁴ NZ Airports submission, “Proposed amendments to the WACC percentile range for information disclosure regulation for electricity lines services and gas pipeline services”, 14 November 2014, p.4.

- 2.8.3 The analysis we will do using the estimates of WACC varies depending on the firm, the time period, whether it is exempt or subject to a price-quality path, and whether we are assessing profitability ex ante or ex post. Different estimates of WACC are potentially required for these purposes. For example:
- 2.8.3.1 WACCs estimated around the time when prices are set (such as the 67th percentile of WACC for firms subject to price-quality regulation) are useful when assessing the returns anticipated by the supplier ex ante.
 - 2.8.3.2 Updated WACCs are useful for understanding how the cost of capital has changed, and this is particularly so for suppliers, such as exempt EDBs, which can reset their prices annually. For such suppliers an estimate of WACC estimated at around the time when the supplier sets its prices is likely to be a useful benchmark for assessing ex ante profitability, (albeit that consideration needs to be given to profitability over time, rather than just looking at a short snapshot of performance).
 - 2.8.3.3 The 67th percentile is our best estimate of the WACC which balances the asymmetric risks to consumers from under and over-investment. It is used by us to set price-quality paths for GPBs, Transpower and non-exempt EDBs. Because the 67th percentile estimate of WACC tries to balance the asymmetric consequences from mis-estimating WACC, it is likely to be a useful guide for assessing whether an exempt supplier has set prices at a level which may not be to the long-term benefit of consumers.
- 2.9 For these reasons, we (and interested persons) need a range of WACC estimates available to us. The amended cost of capital IMs will require us to calculate and publish all of those estimates annually (ie, 25th percentile, mid-point, 67th percentile, and 75th percentile, on both a post-tax and vanilla basis). Which estimate(s) of WACC will be used in any particular analysis will depend on the context. The IMs only set out which WACCs we must estimate and publish, and are therefore potentially able to be used by us in our analysis. They are then also available to interested persons. We accept that having multiple WACCs could potentially be confusing to some interested persons, but that is a matter to be addressed when we set information disclosure requirements, and when we undertake summary and analysis. As the 67th percentile estimate of WACC balances the costs to consumers from under or over-investment from mis-estimating WACC, we think it is a relevant benchmark for all regulated suppliers, including exempt suppliers. We consider that it may be useful for assessing supplier performance to have the 67th percentile of WACC available.
- 2.10 Precisely what published estimates of WACC should also be disclosed by a regulated supplier when they publish their required information disclosures are specified in the ID determination. We will consult on subsequent revisions to those ID requirements at a later date, if any.

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

- 2.11 Our final decision is to use the 67th percentile estimate of post-tax WACC as a limit, when determining the value of commissioned assets under particular provisions of the IMs. This change takes effect as of the commencement dates specified in the amendment determination and discussed further below; it does not require subsequent changes to the ID requirements before suppliers are required to apply it.
- 2.12 Previously, the 75th percentile estimate of post-tax WACC was used to limit the cost of financing that suppliers subject to price-quality regulation could apply under GAAP when determining the value of commissioned assets for information disclosure purposes.¹⁵ The 75th percentile estimate of post-tax WACC was also used in similar provisions in the CPP parts (ie, Part 5) of the EDB IM Determination, GDB IM Determination and GTB IM Determination. Specifically, the 75th percentile estimate of post-tax WACC was also used to limit the cost of financing regulated suppliers could apply under GAAP when determining the value of an asset forecast to be commissioned when applying for a customised price-quality path.¹⁶
- 2.13 In our revised draft decision, we consulted on changing from the 75th to the 67th percentile for the purposes discussed at paragraph 2.12. No submissions were received on this point. This final decision confirms the approach taken in the draft decision.¹⁷

Implementation of our decisions

- 2.14 The timing for the changes introduced by this amendment is aligned, to the extent possible, with the default and individual price-quality path resets for electricity lines services and gas pipeline services.

¹⁵ 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] 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.

¹⁶ 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 2012* [2012] NZCC 27; and clause 5.3.11(3)(b) of the *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28.

¹⁷ In the case of Transpower, no explicit amendment is required to Part 3 of the IM determination relating to individual price-quality paths, because Subpart 3 of Part 3 specifies that assets are to be valued for price-quality regulation purposes in accordance with the method used in Subpart 2 of Part 2 of the IMs (with necessary modifications).

2.15 This means that the 67th percentile estimates for information disclosure will apply for the first time:

2.15.1 for electricity distributors, to the 2015/16 information disclosure year;

2.15.2 for Transpower, to the 2015/16 information disclosure year;

2.15.3 for gas pipeline businesses, to the 2017/18 information disclosure year.