

From the Electricity Networks Association

**Submission on  
"Invitation to have your say on whether the  
Commerce Commission should review or  
amend the cost of capital input  
methodologies"**

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13 March 2014



The Electricity Networks Association makes this submission along with the explicit support of its members listed below.

Alpine Energy Ltd  
Aurora Energy Ltd  
Buller Electricity Ltd  
Centralines Ltd  
Counties Power Ltd  
Eastland Network Ltd  
Electra Ltd  
EA Networks Ltd  
Electricity Invercargill Ltd  
Horizon Energy Distribution Ltd  
Mainpower NZ Ltd  
Marlborough Lines Ltd  
Nelson Electricity Ltd  
Network Tasman Ltd  
Network Waitaki Ltd  
Northpower Ltd  
Orion New Zealand Ltd  
OtagoNet Joint Venture  
Powerco Ltd  
Scanpower Ltd  
The Lines Company Ltd  
The Power Company Ltd  
Top Energy Ltd  
Unison Networks Ltd  
Vector Ltd  
Waipa Networks Ltd  
WEL Networks Ltd  
Wellington Electricity Lines Ltd  
Westpower Ltd



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# 1. Introduction

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1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission on the Commerce Commission in response to its “Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies” (“Consultation Paper”).

## 1.1 Summary

2. The ENA represents the 29 electricity network businesses (ENBs) in New Zealand, the great majority of which are owned by Consumer or Community Trusts, as well as ENBs that are owned by non-consumer owners. Despite the differences in ownership structure and the strong consumer representation, all ENBs take the view that the prospect of the Commission making ad hoc changes to the WACC IM outside of the formal periodic IM review process is unsettling to investors and undermines the certainty that was intended to be provided by the IM framework.
3. In addition, all ENBs take the view that the 75th percentile of the WACC range represents an appropriate point to select for setting regulated prices. In the ENA’s view the 75th percentile approach to setting WACC balances the need to ensure prices are reasonable to consumers and deliver fair returns to investors in order to incentivise long-term investments.
4. ENA submits that the Commission should determine not to prematurely review the WACC IM (or a more narrow review of the WACC percentile) for the following key reasons:
  - (a) The 75th percentile remains appropriate to incentivise investment given the uncertainty associated with estimating the WACC;
  - (b) There is insufficient time to undertake a comprehensive WACC review, which would be necessary in light of the inter-dependencies between WACC and other critical components of the regime, and the competing resource needs of undertaking a robust DPP reset for the ENBs;
  - (c) A narrow or rushed review of the WACC IM would likely cause greater uncertainty or loss of confidence in the regime. Delaying review of this issue until the scheduled seven-year IM review would not cause lingering uncertainty any more than the requirement for the Commission to undertake periodic IM reviews;
  - (d) The as yet unknown outcome of comprehensively reviewing the 75th percentile cannot be presumed to be a total rejection of such an adjustment.

5. While consumers (and even experts<sup>1</sup>) often consider that ENBs are low risk and therefore should face very low returns, the reality is that an ENB making an investment today will typically, at best, break-even on that investment in 45 years time (when the return of investment is fully recovered through depreciation allowances), but through that life-time face asymmetric risks associated with:
- (a) technological change (there are no guarantees that advances in distributed generation and storage will not eventually displace ENB's investments or lead to asset write-downs)<sup>2</sup>;
  - (b) catastrophic events (even though there is some protection of the RAB in regard to damaged assets, ENBs face demand and de-population risk that cannot be insured, scenarios that have been starkly demonstrated by the Canterbury Earthquakes and Hurricane Katrina<sup>3</sup>;
  - (c) regulatory/political risk (down-side risks substantially exceed upside risks)<sup>4</sup>;
  - (d) The calculation of allowable revenues involves a deduction of CPI-based revaluations from revenue allowances, leading to substantial proportions of revenue recovery being pushed into the future, with the consequence that the risks identified in points (a) to (c) above are heightened.<sup>5</sup>
6. While it has not been the theoretical intent of the 75th percentile WACC to compensate for such risks (being purely intended to deal with uncertainty in parameter estimates) in practice because no specific allowances have been made for the risks identified above, the 75th WACC percentile is the only source of buffer to compensate for these factors.<sup>6</sup>
7. If the Commission were to depart from use of the 75th percentile, ENA submits that the inter-dependencies between risk and return must be considered in the setting of other regulatory variables. There would likely be a severe loss of confidence in the Part 4 regime overall if the issue of the WACC percentile was considered in isolation of these wider effects.

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<sup>1</sup> See for example paragraph [1472] in WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013]. ("Wellington Airport & Ors v Commerce Commission")

<sup>2</sup> For example, the Electricity Authority recently provided the ENA a piece of analysis it has undertaken showing that EDBs are likely to be at significant risks of economic write-downs resulting from reductions in the costs of distributed generation by photo-voltaics.

<sup>3</sup> As a result of the flooding and damage caused by Hurricane Katrina, Entergy New Orleans filed for Chapter 11 bankruptcy protection as revenues from remaining customers were inadequate to fund substantial repair costs.

<sup>4</sup> Indeed, it is hard to conceive of upside regulatory or political intervention that would provide any "super profits" that offset downside risks. For example, in recent years changes to distributor prudential requirements and consumer liability provisions under the Electricity Industry Participation Code have placed increased costs and risks on EDBs, without immediate corresponding changes to regulated price paths.

<sup>5</sup> This point applies to EDBs only, as Transpower is permitted to receive its full nominal return in cash each year, whereas EDBs receive their returns partly in cash (around 75%) and partly in capital gains (25%).

<sup>6</sup> It is important to note that the ENA does not accept that this is an appropriate role for the 75<sup>th</sup> percentile, but it has become the Commission's practice to use it for such.



8. Experience shows that the issues involved in determining the appropriate WACC are not simple to resolve and involve the collection of considerable evidence. We expect a robust review of the WACC-IM and inter-dependencies would take a period of at least 12 months.
9. In making a decision to review the WACC IM at the legislated seven-year timeframe, the Commission should take strong comfort that, notwithstanding the Court's obiter dicta:
  - (a) the experts involved in advising on WACC through the IM-setting process supported setting the WACC above the mid-point;
  - (b) that selecting high points in the WACC range is a common regulatory practice (e.g., the AER in its recently released WACC Guideline adopted the very top of its equity beta range of 0.4 to 0.7, which has been a consistent practice)<sup>7</sup>;
  - (c) studies of the cost of lost load show that under-investment is substantially more costly to consumers at multiples of the per unit electricity price<sup>8</sup>.
10. In addition, the Commission and ENBs are about to embark on a likely intensive period of resetting the DPPs with some important deliverables focussed on delivering long-term benefits to consumers as well as complex technical issues involved in establishing reliable forecasts of required operating and capital expenditures. An extensive discussion on WACC is likely to severely detract from robustly working through these issues.
11. We provide more detailed comment on these points in the body of our submission.
12. The ENA's contact person for this submission is:

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<sup>7</sup> AER, *Explanatory Statement, Rate of Return Guideline*, December 2013

<sup>8</sup> See for example, Electricity Authority (2012) *Investigation into the value of lost load in New Zealand – Summary of findings*

## 2. Detailed comments

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### 2.1 Background

13. As stated in paragraph 7 of the Commission’s Consultation Paper, the Court raised a number of queries in relation to the Cost of Capital IM including:
- (a) “the appropriateness of using an estimate of the weighted average cost of capital (WACC) above the mid-point estimate to set price-quality paths;
  - (b) whether to adopt a ‘split’ (or ‘tiered’) cost of capital;
  - (c) our [the Commission’s] rationale for a term credit spread differential (TCSD) allowance; and
  - (d) whether to retain the simplified Brennan-Lally Capital Asset Pricing Model (CAPM), given the effect of the ‘leverage anomaly’.”
14. The Court did not send these matters back to the Commission for further review or find that MEUG had presented any materially better alternatives, but was mindful that the Commission would be able to consider evidence further when the IMs came up for review in the mandatory seven year review period<sup>9</sup>:
- “In reaching this decision not to amend the IM in respect of the use of the 75th percentile for DPP/CPP regulation, **we are mindful that the IMs will be reviewed. At that time, we would expect that our scepticism about using a WACC substantially higher than the mid-point, as expressed above, will be considered by the Commission.** We would expect that consideration to include analysis – if practicable – of the type proposed by MEUG. We would also expect the Commission to consider MEUG’s two-tier proposal in light of our observations. We acknowledge that further analysis and experience may support the Commission’s original position. But they may not...” (emphasis added)
15. The Commission has recognised too that the Court drew reference to the importance of undertaking rigorous analysis to make a determination:
- “... there exists as a matter of theory the potential for asymmetrical consequences should the WACC be set too low or too high. Which of these consequences will carry with it the greatest social damage is not a matter solely for theory, however, but **for robust empirical examination, well-guided by theory, of the actual facts** of any particular case.”(emphasis added)
16. The Commission has raised in its Consultation Paper a number of specific questions as follows:
- (a) “Are the positive incentives provided by using the 75th percentile WACC significantly weakened until we address the concerns raised by the Court?

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<sup>9</sup> Paragraph [1486] Wellington Airport & Ors v Commerce Commission.

- (b) Should we bring forward a review of the cost of capital IMs?
  - (c) If not, should we consider an amendment to the cost of capital IMs solely of the 75th percentile WACC estimate used for setting price-quality paths?
  - (d) Is there any other option that avoids the risk of locking in higher prices for electricity consumers, if we were to later conclude that the uplift should be reduced or is not warranted?
  - (e) What evidence is there in support of either the 75th percentile or credible alternatives?
  - (f) In selecting an appropriate WACC percentile, how significant is it that regulated outputs are inputs to other sectors of the economy?"
17. Additionally, at paragraph 30, the Commission also seeks feedback on:
- (g) "what a realistic timeframe for doing a comprehensive and robust review would be, and when such a review should start;
  - (h) what the likely impact of doing a review early would be on regulatory certainty, incentives for efficient investment, and confidence in the Part 4 regime; and
  - (i) whether it would be appropriate to review the cost of capital IMs in isolation from the other IMs, given that this might mean any inter-dependencies would not be able to be appropriately considered."
10. In the following sections we address these specific questions. ENA notes that while the Commission's Consultation Paper raises other WACC issues arising from the High Court judgment (i.e. the TCSD and the 'leverage anomaly'), the Commission is only proposing to consult (in the absence of a full IM review) on the matters raised by certain interest groups.

## **2.2 Are positive incentives of current use of 75<sup>th</sup> percentile weakened? Should the IM Review be brought forward? Should an amendment only to the 75<sup>th</sup> percentile be considered?**

11. The first three of the Commission's questions (a) to (c) are highly related so we address them jointly in this section.
12. In determining the use of a 75<sup>th</sup> percentile for WACC used in setting regulated prices, the Commission reasoned (as it has since 2004<sup>10</sup>) that it is important to err on the side

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<sup>10</sup> In 2004 the Commission published Lally (2004) *The Weighted Average Cost Of Capital For Gas Pipeline Businesses*, which recommended selection of a WACC from the upper end of a calculated WACC range. Dr Lally's

of caution in setting the allowed return on investment given uncertainty in measuring the various parameters that input to the WACC calculation and the adverse consequences to consumers of under-investment. This has been a consistent position through, for example, the Gas Authorisations, Transpower's regulated price paths, the IMs themselves, and consistently in similar regulated decisions under the Telecommunications Act to ensure that incentives to invest are promoted.

13. As demonstrated by reductions in Vector's share price by circa \$200 million when the Commission made the following statement, uncertainty has only arisen as a result of the Commission's announcement that it might examine the issues relating to the 75<sup>th</sup> percentile, not the High Court's obiter dictum:

“The Commission intends to release a consultation paper later this month which will seek the views of interested parties on whether the Commission should consider reviewing or amending the input methodologies for the cost of capital in respect of this issue.”<sup>11</sup>

14. While the fact that legislated periodic IM reviews will always create a possibility that new information or evidence may change the practice of adopting the 75<sup>th</sup> percentile, it would be an unscheduled review of the IM that creates uncertainty, especially when the Courts only expressed a view (in obiter dicta) that this is an area that the Commission could examine at the point in time the IMs are reviewed.<sup>12</sup>
15. In ENA's submission, a greater harm to investor certainty would be caused by:
  - (a) Undertaking an IM review outside of the legislated seven-year IM review path;
  - (b) Undertaking a rushed or narrow review of the WACC IM, without taking into account the broader regulatory and market environment that the WACC IM relates to.
16. ENA Members would be particularly concerned if the scope of any IM review (whenever it takes place) seeks only to review the 75<sup>th</sup> percentile without considering other inter-related elements of the regulatory and market environment facing ENBs. Risk and return are inextricably linked: the ENA submits that it is impossible to have a proper discussion of the acceptable rate of return absent a comprehensive discussion of the risks that ENBs bear due to the business environment we operate in as well as regulator-determined risk allocations, the role of insurance and self-insurance or other mechanisms that ensure ENBs have a reasonable expectation of being NPV positive over the lifetimes of investments.<sup>13</sup> Moreover, review of the 75<sup>th</sup> percentile adjustment should be coupled with more rigorous modelling and analysis of the WACC standard error estimate from which it is derived.

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views became synonymous with the Commission's through-out the Airports enquiry, gas price control enquiry, and setting of thresholds for EDBs.

<sup>11</sup> On 7 February the Commission established a web-page making it clear that it was open to a potential review.

<sup>12</sup> Paragraph [1486] *Wellington Airport & Ors v Commerce Commission*

<sup>13</sup> For example, as a result of the Orion CPP determination which allocates demand risk of a catastrophic event to EDBs, forecasts of expected demand need to incorporate the probability weighted impacts of natural disasters.

17. At paragraph 36, the Commission suggests that one way that the risks of undertaking a narrow review of the use of the 75<sup>th</sup> percentile could be addressed is by undertaking reasonableness checks. While such checks are potentially helpful in ascertaining the comparability of resultant WACCs compared to overseas jurisdictions, such checks are likely to be too ‘coarse’ to be able to meaningfully inform on inter-dependency issues. Indeed, far from diminishing consideration of inter-dependencies, reasonableness checks reinforce the need for inter-dependencies to be carefully analysed and understood in their own right so that like-for-like comparison can be made. This necessarily requires that the Commission consider the market and regulatory environments confronting both NZ regulated businesses and any overseas comparators, including accounting for how risks are dealt with, allocated or insured/self-insured.<sup>14</sup>
18. In addition to the need to ensure there are like-for-like comparisons, ENA also observes that reasonableness checks are unlikely to be determinative, as ranges are likely to be wide and therefore inconclusive.
19. In summary, ENA submits that investor certainty and confidence would be best served by undertaking the WACC IM review comprehensively as part of the legislated seven year reviews of IMs. While a residual uncertainty exists by virtue of the fact that the WACC IM would be reviewed in future, this is no different from the uncertainty that arises from the legislated requirement to review the IMs every seven years. In that regard, the ENA submits that the investment incentives relating to the use of the 75<sup>th</sup> percentile WACC would not be diminished by retaining the timing of the WACC IM review at the legislated seven year timeframe. What has created unnecessary uncertainty for investors is the Commission floating the prospect of ad hoc reviews of selected WACC issues outside the intended IM review cycle.

## **2.3 Is there an option to avoiding locking in the 75<sup>th</sup> percentile WACC until a review? How significant is it that electricity is an input to other sectors?**

20. In this section we jointly address the Commission’s fourth and sixth questions.
21. The ENA considers that if the Commission does not change the WACC IM prior to the 2015 ENB DPPP reset or Transpower’s IPP, it is not possible to re-open price paths for any subsequent change in views on the desirability of setting WACC at the 75<sup>th</sup> percentile. This is because the legislation clearly constrains the circumstances when claw-back applies or DPP’s may be reopened in response to changes in IMs.
22. However, despite this constraint ENA submits that the imminence of the DPP reset is not good reason to rush a review of the WACC IM, or narrowly review only the choice

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<sup>14</sup> For example, New Zealand distributors are required by regulation to offer a low fixed charge option to residential consumers, and are therefore highly constrained in their ability to manage asset stranding/volume risks compared with overseas comparators.

of WACC percentile. Greater investor/economic harm is likely to be caused by such an approach.

23. The difference between the 75<sup>th</sup> percentile vanilla WACC and 50<sup>th</sup> percentile is 0.7%. Based on the Commission's last cost of capital determination for ENBs<sup>15</sup> as an indicator of the number that may be used at the 2015 reset, the 75<sup>th</sup> percentile may fall from 8.77% used in the 2013 reset to 7.41%, with a corresponding 50<sup>th</sup> percentile vanilla WACC of 6.69%. Assuming CPI of 2%, real returns to ENBs would fall to around 5.4% at the 75<sup>th</sup> percentile and 4.7% at the 50<sup>th</sup> percentile.<sup>16</sup>
24. It is clear from these numbers that at the 75<sup>th</sup> percentile, ENBs will not be high yielding businesses. From an investor perspective, a 0.7% difference in yield is highly material to whether an investment is NPV positive and hence incentives to invest, but this flows through to very small impacts on end-user prices.
15. In contrast, the cost to consumers of under-investment would be very large. Studies of the value of lost load, for example, place values at many multiples of per unit electricity charges.<sup>17</sup>
16. Furthermore, it is by no means a given that review of the 75<sup>th</sup> percentile would automatically lead to adoption of a 50<sup>th</sup> percentile WACC. For example, in its Consultation Paper<sup>18</sup> the Commission has noted the work of Professor Ian Dobbs who makes the case that:

“...a strong case for an uplift (at percentile values in the high 80s or 90s).”
17. In response to the Commission's question: how significant is it that electricity is an input to the rest of the economy in relation to the choice of WACC percentile, the answer is two-fold:
  - (a) In relation to price, the significance is immaterial to allocative or dynamic efficiency;
  - (b) In relation to investment and quality of supply, it is critical that the WACC is at a sufficient level to induce investment to provide valuable services to consumers.

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<sup>15</sup> Commerce Commission *Cost of capital determination for electricity distribution businesses to apply to a customised price-quality path proposal [2013]* NZCC 16 30 September 2013.

<sup>16</sup> The Reserve Bank's inflation forecast is for inflation to increase to 2.1% in March 2016.

<sup>17</sup> See for example, Electricity Authority (2012) *Investigation into the value of lost load in New Zealand – Summary of findings*. The EA's survey results found a mean non-load weighted VOLL of \$23,686 / MWh and a mean load-weighted VOLL of \$8,167/MWh for an eight hour outage. Conservatively, using a proxy \$275 / MWh delivered energy cost (from MBIE's November 2013 Quarterly Survey of Domestic Electricity Prices) the average value of unserved electricity is at least 30 times the per unit price, and for many consumers will evidently exceed 86 times the delivered energy price using the non-load weighted VOLL.

<sup>18</sup> Footnote 28, page 11.

## 2.4 Evidence to support the 75<sup>th</sup> percentile

28. In this section, we respond to the Commission's request for evidence to support the use of the 75<sup>th</sup> percentile. In particular, the Commission has asked for evidence on the appropriateness of the 75<sup>th</sup> percentile or to support other percentiles, referring to valuations of Transpower and the purchase of Powerco at a multiple above RAB value.
29. ENA submits that at this point in the process, and given the timeframes provided for in the Consultation Paper, it is not possible to provide a comprehensive set of evidence on WACC estimates or percentiles. It is important to recognise the Court's reflection that there should be a "robust empirical examination" of issues relevant to calculation of the consequences of setting a WACC too high or low.
30. Nevertheless, we note that in relation to the points raised on Transpower and Powerco's valuations:
  - (a) There is mixed evidence from independent analysts on their views of whether the 75<sup>th</sup> percentile generates valuations above or below their valuations;
  - (b) Acquisition premiums are common and relate to numerous sources of value beyond the immediate investment in RAB assets. We understand that the AER has specifically discounted the use of RAB multiples in informing its WACC decisions for this very reason.<sup>19</sup>
31. In regard to the Commission's formal use of statistical methods to determine a percentile within a WACC range, the ENA observes that while the Commission is unique in adopting such formal methods, the Commission's approach of selecting a point in the upper end of a range is consistent with other regulators' practices. For example, the AER has recently established a WACC guideline, which sets the value of equity beta at 0.7, the top end of a calculated range of 0.4 to 0.7, an approach which has been consistently been applied across determinations.
32. In regard to evidence to support different percentiles, ENA submits that the Commission should have regard to the Australian approach of only making changes to the WACC where there is persuasive evidence to support such change. Change, or even the prospect of change, in itself causes investor uncertainty and heightens perceptions of risk, so the Commission should ultimately ensure that persuasive evidence exists to depart from its long-standing approach of using the 75<sup>th</sup> percentile.
33. Given the three-week timeframe for responses to the Consultation Paper the ENA is not in a position to provide evidence on the choice of WACC percentile, but as stated earlier, the ENA emphasizes that the Commission should not consider return without considering risk: fundamentally this is what finance theory is based on. ENA is particularly concerned that the Commission may contemplate a narrow review of the choice of percentile, absent this broader consideration of risk.

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<sup>19</sup> AER, *Explanatory Statement, Rate of Return Guideline*, December 2013, pages 34 and 77

34. As stated in our summary comments, it is incorrect to suggest that ENBs are low risk investments. In particular, given the regulatory approach to cost recovery over lengthy physical asset lifetimes, ENBs face significant asymmetric risks arising from three key sources that are asymmetric in their impacts on ENBs' returns and the recovery of sunk investment costs:
- (a) technological change (there are no guarantees that advances in distributed generation and storage will not eventually displace ENB's investments or lead to asset write-downs);
  - (b) catastrophic events (even though there is some protection of the RAB in regard to damaged assets, ENBs face demand and de-population risk that cannot be insured, scenarios that have been starkly demonstrated by the Canterbury Earthquakes and Hurricane Katrina<sup>20</sup>); and
  - (c) regulatory/political risk (down-side risks substantially exceed upside potential).
35. To date these factors have not been explicitly quantified or accounted for in setting regulated prices, so the practical effect is that the only recompense or buffer for accounting for such risks is implicit in the 75<sup>th</sup> percentile, even though this is not the intent of adopting the higher percentile, which is to account for uncertainty in estimating parameter values. Whilst the ENA does not agree that the use of the 75<sup>th</sup> percentile is sufficient to compensate for catastrophic event risk, the Commission did indicate in its decision on Orion's CPP application that it felt that it did provide a level of compensation/buffer. Accordingly, any change from the 75<sup>th</sup> percentile would require these issues to be considered explicitly.
36. It is also apparent from the following quote that when commenting on the merits of the 75<sup>th</sup> percentile, the Court did not consider the character of New Zealand's DPP/CPP regime and the risks that it involves to ENBs. In commenting on the impacts on consumers and suppliers of setting a WACC above the mid-point the Court stated:
- “[1472] In the first place, the expectation of earning (only) a normal return on new investment ought to be an attractive proposition for a regulated supplier. In the price control regulatory framework, the return is almost guaranteed. Each supplier is a monopoly. The normal regulatory imperative in such circumstances is to prevent suppliers from over-investing. Why then, should higher likely returns be provided?”
37. The ENA strongly disputes that returns are “almost guaranteed” or that it is reasonable to assume that “monopoly” status will endure over the long-term, such that ENBs are assured of recovering their sunk investment costs and return on investment requirements.
38. In respect of the character of the DPP/CPP regime, while it seeks to avoid the high costs of detailed building blocks regulation through setting DPPs that can cost-

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<sup>20</sup> As a result of the flooding and damage caused by Hurricane Katrina, Entergy New Orleans filed for Chapter 11 bankruptcy protection as revenues from remaining customers were inadequate to fund substantial repair costs.



effectively be applied across non-exempt ENBs, this carries the risk that any forecasting methodology involved systematically understates the levels of capex and opex required by ENBs to efficiently operate and invest in their networks. The Orion CPP experience has highlighted that applying for a CPP is far from a costless or riskless exercise. While it is not the intended role of setting the WACC at the 75<sup>th</sup> percentile, it does somewhat mitigate the risk that an ENB will find itself in a dead-band where the DPP is set below the level where an ENB can efficiently achieve the WACC, but where the costs and risks of applying for a CPP are prohibitive.

39. In summary, the ENA submits that it is essential that when considering evidence on the appropriate method of establishing the WACC a robust, empirically-based process is undertaken that considers both returns and risk. The High Court highlighted that there was not a large amount of empirical evidence produced by any party to support the choice of percentile. The ENA agrees with the Commission that it is unlikely in the time available prior to the DPP reset for such empirical research to be completed in a robust manner with the inter-dependencies with other key input methodologies properly considered.

## 2.5 Timeframe

40. At paragraph 52 the Commission sets out a potential timeline for making amendments to the IM determination as follows:

Process step	Indicative date
This invitation (and request for evidence) published	20 February 2014
Submissions due on this paper	13 March 2014
Notice of intention to amend the cost of capital IMs	By the end of March 2014
Draft amendments to the cost of capital IMs	23 June 2014
Submissions due on draft amendments	4 August 2014
Cross-submissions due on draft amendments	18 August 2014
Final amendments to IM determinations	30 September 2014

27. In respect of the proposed timetable if the Commission did decide to proceed with a review, ENA is concerned that between the Notice of Intention and the publication of a Draft Determination, there is to be no communication from the Commission on the scope of matters that would be considered. This would make it impossible for stakeholders to anticipate the issues that would be addressed and therefore to carry out targeted preliminary work to prepare evidence suitable for an IM process. We therefore submit that a vital first step would be to outline the scope of the review and the issues to be addressed.
28. The Commission proposes a twelve week timeframe for the Commission to prepare its draft determination and a seven week timeframe for the preparation of submissions and a further two weeks for cross-submissions. Given both the theoretical and empirical issues involved, ENA submits that the timeframes for submitters and the overall process are unreasonably short. We understand that despite a lengthy regulatory history in Australia associated with determining regulated WACCs, the recent development of

the WACC guideline took over 12 months. Given the truncated timeframe proposed, this reinforces ENA's submission that a comprehensive WACC review should take place at the scheduled seven-year review point, but at the very least the Commission would need to be highly transparent about the research it was undertaking very early in the process, so that submitters' abilities to respond are not compromised and that there is a longer period provided for cross-submissions of at least four weeks.

29. A comprehensive review of the appropriate WACC percentile to use, as suggested by the High Court, will require research and analysis of suitable, robust 'loss function' models and methodologies. Following which parameter estimates will be required to implement the preferred methodology(ies). To enable meaningful consultation it is important that these two stages occur sequentially with interested parties able to make submissions at each stage. Were these two stages to be conflated there would be a high risk that interested parties would have insufficient time to analyse practical application of the preferred methodology(ies). Moreover, there could be significant waste of resources by parties comprehensively estimating parameters for models that end up being discarded.
30. In addition, on such highly technical matters as WACC, it has proved important to use "hot-tubbing" processes to narrow down to the points of disagreement in inevitably academic debates to avoid the risk of experts talking past each other. ENA submits that this process step should be undertaken in any review.
31. ENA also submits that if the Commission were to proceed with either a full or a partial review of the WACC IM, the Commission would need to tightly manage this process with the parallel DPP reset process. As noted ENA is opposed in principle to an ad hoc partial review of the WACC IM. ENA is highly concerned that if the Commission undertakes a WACC IM review, at the same time as the next DPP reset, there will be insufficient resources available to both the Commission and ENBs to establish reset prices that meet the requirements of Part 4. In particular, there are critical issues to be resolved in respect of:
  - (a) Forecasting methods for capex, opex and real revenue growth;
  - (b) Development of a menu regulation framework for trialling during this reset period;
  - (c) Developing a regime that better measures quality performance and develops a set of incentives linked to actual quality outcomes;
  - (d) Development of a rolling incentive scheme to ensure there are time-invariant incentives to improve efficiency across a regulatory period; and
  - (e) Development of energy efficiency incentives consistent with the requirements of section 54Q.
32. ENA submits that in light of this broader work programme, this is further reason that the Commission should not prematurely undertake the WACC review.
33. Insofar as the timing of the formal periodic WACC IM review is concerned, there is an expectation within ENA members that this will occur toward the end of the mandated seven year review period – with sufficient time allowed for meaningful consultation. If

the Commission is concerned to promote certainty around the IM review process it should signal well in advance its proposed review timetable.