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**SUBMISSION ON WHETHER THE COST OF CAPITAL INPUT METHODOLOGIES SHOULD BE REVIEWED**

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to provide a submission on the Commerce Commission's (**Commission**) "Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies" (the paper) issued by the Commission in February 2014.
- 2 The Electricity Networks Association has also submitted on the paper. Orion endorses the ENA submission.

**General observations**

- 3 For Orion, while we understand the need to review regulation from time to time, we do not believe the IMs should be reviewed *now*, and in particular not before EDB prices are reset from 1 April 2015.
- 4 We note what we consider to be the most important comment in the paper: in para 26 the Commission writes:  
  
*...we think it is unlikely that a comprehensive and robust review could be completed within that [before the November 2014 DPP reset] time frame.*
- 5 We agree: we believe the process for IM review set out in section 52V of the Commerce Act cannot be properly followed in that timeframe. Moreover, given that all elements of the WACC and regulatory regime more generally are interrelated, we do not believe that it is possible to perform a robust partial review of one aspect of the IMs in isolation from the entirety of the IMs.

- 6 The paper couches much of its discussion in terms of certainty. A regulator should seek to provide as much certainty as possible regarding process. Yet the paper is doing the opposite. In our view the correct and proper response from the Commission to the comments on WACC in the High Court decision, is that it has noted them and will take them into account when the IMs are next reviewed before 2018.
- 7 The fact that *some* parties are using *some* of the Court's comments to back their call for the Commission to undertake an immediate review is a form of further appeal, albeit by informal means, and effectively assumes the formal appeal will be upheld.<sup>1</sup> The formal appeal will be heard in due course and it may indeed lead to a change to the relevant IMs. The outcome of the appeal is of course uncertain, but that uncertainty cannot be avoided, whatever effect it has already had, or is having now.
- 8 But the paper actually *adds* to uncertainty by initiating further, hurried and possibly partial consultation on the same topic, even though the Court upheld the cost of capital IMs. Moreover, if the Commission does review the IMs concurrently with the appeal process it risks doing something that turns out to be inconsistent with whatever the Court decides.
- 9 However, appeal or no appeal, we do not see that there is good reason to review the IMs now. The expectation of the regulated entities was that the IMs, once set (including exhausting any appeal process), would be reviewed by the Commission only periodically (every seven years). While the seven year periods are maximums, they signal an expectation that IM reviews would not be frequent, and we would argue that the only reason to materially bring forward such a review would be discovery of a problem in application of the IMs (such as arose in the course of Orion's CPP process) or some technological or other change that renders them obsolete. The review periods determine the frequency of material change to the IMs, and therefore the certainty of the regulatory regime and the volatility of regulatory impact on the regulated entities. In other words, 'certainty' is only 'guaranteed' for those periods.
- 10 The paper is wrong, in our view, to place an emphasis on what the outcome *might be* if the Commission maintains the IMs through a further price reset, *and* the appellants are successful. If the appeal is successful, section 53ZB of the Commerce Act provides for claw-back.
- 11 On the other hand, if the appeal is unsuccessful yet the Commission in due course reviews the IMs and as a result the WACC is reduced, the returns earned in any preceding regulatory periods cannot be judged to have been excessive, as any change is simply reflecting regulatory developments, and will appropriately apply from the subsequent reset. This is nothing more than the truism that, had past regulatory settings been different, the outcomes for various stakeholders could have been different.

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<sup>1</sup> For example the Consumer NZ / EMA / MEUG letter quoted in para 17 of the paper, page 8.

12 The Commission suggests that:<sup>2</sup>

- 12.1 the High Court's commentary increases the expectation that the median will be used in future; and
- 12.2 therefore, the promotion of investment associated with using the 75<sup>th</sup> percentile now is weakened (given the relatively long life of assets); and
- 12.3 therefore, the Commission should review the use of the 75<sup>th</sup> percentile early so as to ensure that the Commission's position on the matter is resolved sooner rather than later so that either:
  - (a) if the Commission decides to move the WACC closer to the midpoint, customers get the benefit of lower prices early; or
  - (b) if the Commission decides to leave the WACC at the 75<sup>th</sup> percentile (or even raise the WACC) then customers get the benefit of stronger investment incentives.

13 Orion rejects the validity of this logic and invites the Commission to consider the precedent that following this logic would create. Essentially, the Commission is saying that anytime an event occurs that causes investors to change their expectations about how aspects of the IMs will evolve in the future, this creates an urgent need to review those aspects of the IMs now.

14 In the current context this "event" is the High Court saying that it had seen no evidence one way or the other on whether the 75<sup>th</sup> percentile should be used and speculating, on this basis, that it may not be necessary/appropriate. In Orion's opinion, this is a very weak basis to justify a reopening of the IMs. If this triggers an early review of that aspect of the IMs, then presumably so would an expert report from leading economists showing that, on the basis of compelling new data, the equity beta should be lowered (or raised) by 0.2.

15 Such a report would have just as big an impact on investors' expectations of the future evolution of the beta as the highly caveated commentary from the High Court. Precisely the same logic as is expressed by the Commission at paragraphs 21 and 22 of its paper would suggest that the beta used in the IMs should be reviewed early. Ultimately, the logic for this early review if applied consistently across the board would destroy the certainty the IMs are supposed to achieve. Essentially, that precedent would suggest that the Commission could and should reopen any aspect of the IM's as soon as it comes to the view that stakeholders believe the IMs will be changed in the future.

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<sup>2</sup> Paragraphs 21 and 22 of the Commission's paper.

- 16 We also note that Orion's customised price-quality path (CPP) has just been set for the next five years on the basis of the 75th percentile WACC, and elements of the Commission's decision rely on the 75th percentile WACC including an implicit allowance for catastrophic risk, an allowance that was not apparent at the time the IMs were determined in 2010. This development is, somewhat surprisingly, not mentioned in the paper. In fact, a reasonable case can be made that investors should expect an even higher percentile to be used given that the Commission now is on the record as arguing that choosing a WACC above the midpoint is intended to compensate for otherwise uncompensated risks to cash-flows.
- 17 We address each of the paper's questions below. In responding to these questions we in no way contradict our overall position that the Commission should not review the cost of capital IMs now. We also emphasise that these are necessarily only very preliminary comments given the very tight timeframe for this consultation.

***Are the positive incentives provided by using the 75<sup>th</sup> percentile now weakened?***

- 18 We believe that the paper only adds to any uncertainty created by the on-going court proceedings. Stakeholders knew and know about appeals, and will have taken and will be taking their own positions on likely outcomes and what they should do in the meantime. In other words, we believe that one of the outcomes that EDBs would not have foreseen is the Commission using elements of the Court's commentary to commence a further review outside of the appeal process and ahead of the IM review timeframes set out in the Act.
- 19 If the Commission proceeds down this path then, not only will the positive incentives provided by using the 75th percentile be further weakened, the positive incentives provided by having a well-defined overall regulatory framework (the IMs) will be weakened. Investors and other stakeholders will see the IM's as, at best, temporary guidance for the Commission – able to be changed inside a year should the Commission feel this is appropriate. Moreover, knowing this, stakeholders will have an incentive to produce material in an attempt to make the Commission feel this is appropriate (such as commissioning the report on beta hypothesised above).

***Should we consider an amendment solely to the 75<sup>th</sup> percentile?***

- 20 No, we submit that the Commission should not.
- 21 As noted above, there is not yet a Court *finding* that the 75<sup>th</sup> percentile is "too high", so the statement in para 31 of the paper that, if it is then consumers might be paying too much, is an unhelpful and arguably somewhat biased tautology.
- 22 Nevertheless, we do not believe it is good regulatory practice to review such matters in a partial way. As stated above, the IMs are an integrated whole. It is not possible to robustly perform a partial analysis of the 75<sup>th</sup> percentile. The 75<sup>th</sup> percentile cannot be examined in isolation. For example, it can't be assumed that if the 75<sup>th</sup> percentile was

reduced to the midpoint, other aspects of the IMs would remain unchanged. Reducing the 75<sup>th</sup> percentile to the midpoint would raise a number of consequential issues. By way of example, reducing the WACC would reduce cash-flows and worsen credit metrics for regulated businesses. In this context, it would be incumbent on the Commission to also re-examine the IM credit rating for the purpose of estimating the cost of debt.

- 23 Similarly, but more specifically, we note that *two* alternatives to the existing approach are discussed in the Court's decision: reducing the WACC to the 50<sup>th</sup> percentile, and introducing a two-tiered WACC. Yet paras 32 and 33 of the paper seem to envisage an immediate review of the percentile can be done with consideration of two tiers deferred. An obvious and clearly undesirable possible outcome of this approach - from a quality of regulation perspective - is that the Commission might now reduce the WACC to the 50<sup>th</sup> percentile, only to return it to the 75<sup>th</sup> percentile - for new investment only - in a few years. We do not follow the reasoning in para 33 that this approach would not further impact on incentives between the first and second actions.
- 24 We very much agree with the possible objection raised in para 36 of the paper that it will be very difficult to properly consider the interdependencies of the WACC percentile with and across the full set of IMs if some are reviewed in isolation.

***Are there any other options for addressing the Court's concerns?***

- 25 Yes, two (which are not really options as they are not exclusive):
- 25.1 In the short term, let the appeals run their course and respond accordingly, and
- 25.2 In the longer term, indicate when the Commission intends to review the IMs (all of them) in line with the relevant legislation.
- 26 As noted above, the concern expressed in para 38 is the wrong way around. The implications of IM reviews, where they result in material changes, will always lead to future outcomes that are different to what has previously happened. It does not follow that past outcomes were bad ones. We also note the incorrect and inappropriate reference to "the risk of locking in higher prices". We think this should be current prices, and it is not a risk. Current prices are what they are and they have been appropriately set according to the current IMs.

***What evidence is there in support of either the 75<sup>th</sup> percentile or credible alternatives?***

- 27 When the Commission reviews the IMs it will appropriate to review all existing and new evidence, including the examples cited in the paper. An example not mentioned in the paper is the position that the Commission took with respect to the rationale for the 75th percentile WACC in its Orion CPP decisions paper, specifically that:

*C5.2 minimal or no compensation above the WACC is required by a diversified investor to take on the demand risk specific to an individual business. **The practical effect of using***

***the 75th percentile WACC (determined under the IMs) is to provide a buffer against the financial impact of catastrophic events.*** <sup>3</sup>[Emphasis added]

- 28 As well as establishing a new argument and justification for using the 75<sup>th</sup> percentile WACC (one that we do not believe was before the Court, and which was specifically not used by the Commission in its original IM documents), this position clearly establishes - in relation to a previous question in the paper - that the percentile cannot be considered in isolation, since the removal of this “buffer” would require a consequential introduction of a separate allowance for catastrophic risk. Indeed, the view that the 75<sup>th</sup> percentile includes some sort of “buffer” for, as yet, largely unquantified but potentially significant risks to cash-flows (as Orion knows only too well) is clearly a major area of further investigation and one that could not be decided in the constrained timeframe proposed. Removing the 75<sup>th</sup> percentile without replacing it with a self-insurance premium - or some other allowance - for catastrophic risk is what Professor Yarrow might call a form of regulatory taking.<sup>4</sup>
- 29 We do, however, agree with the approach set out in para 44 of the paper of “...collecting evidence and exploring analytical approaches now...”, but only because this is really just the Commission noting that it is keeping up to speed. This is presumably *always* appropriate irrespective of where we are in the regulatory cycle?

***How significant is it that regulated outputs are inputs to other sectors of the economy?***

- 30 We note the following:
- 30.1 There can be no presumption (at least for non-exempt EDBs) that prices are in fact “...higher than the resource cost of producing the regulated outputs...”. In fact the current presumption must be that prices accurately reflect costs, since current prices have been set by reference to the current IMs.
- 30.2 Even if prices are in fact higher (or lower) than costs, it is usually held that, due to inelastic demand for electricity, the consequent static efficiency impacts will be quite small.
- 30.3 Partly as a consequence of the point just made, it is also usually held that the adverse dynamic efficiency effects of under-investment far outweigh any static efficiency gains that might accrue from more accurate prices. For example, we believe that, had Orion not undertaken its network strengthening programme in the 20 years before the 2010/2011 earthquakes, the economic consequences of the earthquakes would have been many times worse. In other words there is significant asymmetric risk associated with network investment. In this sense at

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<sup>3</sup> Commerce Commission, *Setting the customised price-quality path for Orion New Zealand Limited: Final reasons paper* – [2013] NZCC 21, 29 November 2013, p 136.

<sup>4</sup> Which is not to suggest that we agree with this justification of the use of the 75<sup>th</sup> percentile WACC, or that there are not sufficient arguments for the use of the 75<sup>th</sup> percentile, or even higher percentile, WACC, absent the “buffer” argument.

least it is very significant that the output of electricity distributors is an input to *all* other sectors of the economy.

### **Concluding remarks**

- 31 Thank you for the opportunity to make this submission. Orion does not consider that any part of this cross submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager - Commercial), DDI 03 363 9526, email [Dennis.Jones@oriongroup.co.nz](mailto:Dennis.Jones@oriongroup.co.nz).

Yours sincerely

A handwritten signature in black ink that reads "D. L. Jones". The signature is written in a cursive, slightly slanted style.

Dennis Jones  
**Industry Developments Manager - Commercial**