MAJOR ELECTRICITY USERS' GROUP

26 November 2010

Karen Murray
Regulation Branch
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Karen

Final Consultation on Input Methodologies for Transpower

This is a submission by the Major Electricity Users' Group (MEUG) on the Revised Draft Transpower Input Methodologies Determination 2010.

MEUG is concerned that the Revised Draft does not clearly indicate inconsistencies in firms' claims about returns required in workably competitive markets are resolved, and reflected in the cost of capital formula. The Input Methodologies (Electricity Distribution Services) Draft Reasons Paper[1] correctly states that "the cost of capital is the minimum expected rate of return to be earned in the long-term for investment to occur." MEUG believe that Transpower's Draft Determination is inconsistent with the Reason Paper method of balancing the interests of the supplier of regulated services, and consumers. Paragraph 6.2.27 provides:

> *In setting the estimated cost of capital, the Commission therefore has to balance the interests of the supplier of the regulated services, and consumers. It has done this by establishing a minimum rate of return that is required to incentivise ongoing investment in regulated services (consistent with s 52A(1)(a)), whilst preventing suppliers from extracting excessive profits in the long-term (consistent with s 52A(1)(d) of the Act)*.

In the absence of a worked example of the application of the methodology it is difficult to know whether and how that minimum has been derived.

For example the Draft Determination does not indicate whether, and if so how, it would reflect and incorporate information such as Transpower's own statements about what return is required to incentivise it to invest, or how the methodology will reflect or weigh inconsistencies in such statements.

[1] Relied upon by the Commission for the Input Methodologies (Transpower) Draft Reasons Paper

Transpower's Chief Executive at the company's public meeting on 24 September made statements that appear inconsistent with Transpower's Draft Determination and Reasons Paper Cross Submission dated 31 August 2010 (the Cross Submission). The Cross Submission covered a number of points raised in MEUG's submission on the Commission's pan industry input methodologies for the weighted average cost of capital (WACC) and the supporting report from Ireland, Wallace & Associates Limited (IWA), dated 13 August 2010.

The Cross Submission argued that:

> *Contrary to the position put by MEUG and IWA, the interests of consumers and the purpose of Part 4 of the Commerce Act are best promoted by ensuring that the actual cost of capital is unlikely to be lower than the Commission's estimate. The approach suggested by MEUG and IWA would be contrary to good regulatory practice and would deliver an unacceptably low cost of capital.*

We wonder whether something has misled Transpower as to the effect of the Draft Determination's approach to gearing in estimating the cost of capital. We suggest that the Determination be reformulated so that it does not lead an important participant to confusion.

The Cross Submission later stated (our emphasis):

> *MEUG proposes that the Commission could consider setting the cost of capital range at the 75th percentile for all new capital and the 50th percentile for all current and already committed or approved capital expenditure.*
>
> *In response, Transpower notes that:*
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>> *- The Commission adopts the 75th percentile WACC in recognition of the errors associated with estimating WACC, and the high social costs associated with underestimation of the cost of capital in a regulatory setting.*
>>
>> *- Even when WACC is set at the 75th percentile level, there is a one-in-four chance that the regulatory WACC estimate will be below the actual cost of capital. Importantly, this estimation error applies to investors' required returns on both existing and new assets. <u>Investors cannot be expected to continue to provide debt and equity capital to a commercial enterprise where there is a substantial likelihood that the regulatory WACC allowance for the entire enterprise will be below the actual cost of capital</u>.*

Transpower argues that a WACC in line with MEUG's suggestions would not be in the interests of consumers because it would not provide enough incentive for investment. But while asserting this to the Commission, Transpower's management has revealed such purported fears are hollow.

In response to a question at the public meeting, Transpower's Chief Executive indicated that even if a rate higher than 7.7% was not achieved <u>none</u> of the planned investment indicated at the meeting or in Transpower's long term planning documents would be affected. Subsequent conversations by MEUG representatives with Transpower Board members and staff supported this statement.

Commission staff attended the public meeting. MEUG believes that the statements are "views before the Commission" and may be capable of being relied upon by the Commission. MEUG is mindful that a merits review after the final input methodologies have been determined, will be conducted "solely on the basis of the documentary information and views that were before the Commission when it made its determination, and no party may introduce any new material during the appeal." It could be important that these statements be unequivocally before the Commission for the purposes of section 52ZA of the Commerce Act.

We have appended a transcript of the relevant question and answer. We also understand that Transpower recorded a video of the meeting in its entirety. The company has uploaded video for all but the relevant part of the meeting to their website. We think it would be prudent for the Commission to request that video from Transpower.

This submission is not confidential.

Yours sincerely

Ralph Matthes
Executive Director

Partial Transcript of Transpower Public Meeting, 24 September 2010.

Question from the Audience:

Jordan Williams

Jordan Williams, Franks and Ogilvie, just a follow-on from Ralph [Matthes]. If you don't achieve from the Commerce Commission a rate higher than the 7 point 7 in your statement of intent, will that affect any of the planned investment? You mentioned 3.8 billion. Will that affect any of that planned investment, will any of that not go ahead?

Patrick Strange

No it's all committed. Obviously if the Commerce Commission set a rate too low that is a concern and not just for Transpower but for electricity throughout New Zealand, public and private companies.