

In the High Court of New Zealand
Wellington Registry

CIV -2011-485-268

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under: the Commerce Act 1986 ("Act")
in the matter of: an appeal to the Court of Appeal under
s 97(1) of the Act
between: **The Major Electricity Users' Group Inc**
Appellant
and: **Commerce Commission**
Respondent

**Affidavit of Ralph Victor Matthes in support of
MEUG's application for leave to Appeal to Court of Appeal**

Date: 13 February 2014
Next Event Date:
Before: Clifford J



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I, Ralph Victor Matthes, of Wellington, executive director, swear:

1. I am the Executive Director of the Major Electricity Users' Group Incorporated ("MEUG"). I have managed MEUG's regulatory advocacy since 1995. I hold a Bachelor of Science in econometrics (University of Canterbury) and a post graduate Diploma in Business Administration (Victoria University Wellington).
2. I am deposing this affidavit in support of MEUG's application for leave to appeal this Court's decision dated 11 December 2013, which declined MEUG's appeals against the Commerce Commission ("Commission")'s cost of capital input methodology determinations ("IMs") for Transpower and Electricity Distribution Businesses ("EDB").

THE IMPORTANCE OF THE APPEAL

3. This proceeding involved a merit appeal of regulatory rules. It is not analogous to a private dispute between parties but affects the general public interest.
4. IMs determine the way monopolistic industries are regulated. IMs for price-quality control have a direct bearing on the prices that consumers pay and given the importance of essential services to commerce and trade, are of significance to the New Zealand economy more generally.
5. Sections 53ZB(2) and 53ZC(2)(b) of the Commerce Act 1986 ("Act") require the Commission to reset price-quality paths and apply claw-back where an IM changes as a result of an appeal under section 52Z and it would have resulted in a materially different price-quality path. This means that if successful, MEUG's appeal is likely to require suppliers subject to price-quality control to compensate consumers for some or all of any over-recovery that occurred under the prices previously charged by the supplier. Section 52D(2) of the Act would require any lowering of prices to be spread over time in order to minimise undue financial hardship to the supplier.
6. The next default price-quality path ("DPP") for electricity lines and the individual price-quality path ("IPP") for Transpower will cover the

regulatory period 2015²⁰²⁰. I understand that the Commission intends to determine these price-quality paths by November 2014. Once they are determined, s 53ZB(1) and 53ZC(2)(b) of the Act prevent the DPP and IPP from being reopened during the regulatory period as a result of an IM change.

7. The Commission is currently consulting on whether to conduct a review of cost of capital IM, in particular the weighted average cost of capital ("WACC") range. On 7 February 2014 it published on its website the following announcement

Further work on WACC

The Commission is further considering the comments made by the High Court relating to the selection of the 75th percentile of the cost of capital range.

In the High Court's decision on the merits appeals of the input methodologies, the Court commented on the Commission's selection of the 75th percentile of the cost of capital range for price-quality regulation of electricity lines and gas pipeline businesses (see Wellington International Airport Ltd and others v Commerce Commission [2013] NZHC 3289). The Commission has also received correspondence from MEUG and BARNZ inquiring as to the Commission's proposed response.

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, and the appropriate scope and timing of any further work. Given the uncertainty that now exists in relation to this significant aspect of the cost of capital, the Commission appreciates that there would be some benefit in considering this issue further and reaching a decision prior to the November 2014 setting of the DPP for electricity distribution businesses and the Transpower IPP.

8. The Commission has given no guarantee that it will review this aspect of the cost of capital IM as a result of the present consultation, nor that such a review would be completed by November 2014. If the IMs are not amended by then, the 75th percentile of the cost of capital range for price-quality regulation would apply not just for the 2010-2015 period,

but right out until 2020, even if the IM subsequently changes as a result of a scheduled review in 2017. The Commission acknowledged before the High Court that the expected outcome of its choice of the 75th percentile when setting price-quality was that regulated entities earn above normal returns (while also stating that it considered this would still be in the long-term interests of consumers). This means that without a review or a successful appeal of the existing IM, there will be 10 years of excess charges for consumers.

AMOUNT OF MONEY IN ISSUE

9. DPP and IPP cover various expected costs including operating costs, base capital costs, tax, return of capital (depreciation) and a return on capital. The return on capital is the product of the cost of capital applied to (or multiplied by) the regulated asset base.
10. Regulated electricity and gas line monopolies currently have regulated asset values of approximately \$15 billion. Small differences in cost of capital therefore result in very large changes in the return on capital.
11. The difference between the December 2010 IM determination of a post-tax WACC of 7.22% at the 75th percentile and 6.49% at the mid-point is 0.73%. This difference multiplied by an aggregated regulated asset value of \$15 billion equals an \$111 million per annum difference in aggregated return on capital to suppliers. To estimate the effect on charges to customers, the \$111 million per annum is grossed up by the company tax rate of 28% to equal \$155 million per annum.
12. There are many simplifying assumptions in the above estimate. For example, the Commission uses vanilla WACC rather than post-tax WACC to set price paths. I have used post-tax WACC in estimating changes because the calculations are easier and we can identify differences in charges paid by consumers and capital charges (i.e. net of tax) received by suppliers. Trying to estimate changes using vanilla WACC would require large models without material gain in accuracy. Regulated asset values also change from year to year.

13. Looking forward from 1 April 2015 when DPP and IPP will be reset for the following 5 years, the prior estimate of \$155 million per annum is, in my view, a reasonable estimate. Summing \$155 million over the next five years equals the total amount of money in issue for customers of regulated electricity and gas monopolies of \$773 million. The money in issue for MEUG members over 2015-20 is much less, approximately \$30 million to 40 million, because we do not count changes in gas prices and MEUG members are either solely or mainly purchasers of electricity transmission services, not distribution services. MEUG members also have relatively flat demand profiles compared to peaky daily demand profiles of other customers. A major component of transmission charges is based on peak demand hence the incidence of transmission charges is greater on other customers.
14. Looking back to the IPP effective from 1st April 2011 and ending 31st March 2015 and the DPP in place 2010-15, I estimate the difference due to the 75th percentile versus the mid-point WACC is equal to approximately \$500 million. Of that, the amount in issue for MEUG members is approximately \$25 million to \$30 million. These retrospective values are lower than the prospective values in the preceding paragraph because of an allowance to reflect lower historic regulated asset bases, uncertainty on whether regulated suppliers not subject to a DPP have priced using the 75th percentile WACC and the current IPP being in place for 4 years not the 5 years for the next IPP.
15. There are other simplifying assumptions made to assess the amount of money in issue. More precision could have been made however that was not viewed as necessary as many members used their own more detailed in-house information to estimate values for their own business. Those calculations were not shared within MEUG but that background knowledge contributed to the confidence in the range of amounts in issue.

16. For all customers of regulated electricity and gas lines businesses the sum of the prospective difference in WACC over the 5 years 2015-20 of \$773 million and the retrospective difference over 2010-15 of \$500 million is in excess of \$1 billion.

Sworn at Wellington
on 13 February 2014



RALPH VICTOR MATTHES

before me:



A Solicitor of the High Court of
New Zealand

