LOYENS & LOEFF

POSTAL ADDRESS P.O. Box 71170
1008 BD AMSTERDAM
OFFICE ADDRESS Fred. Roeskestraat 100
1076 ED AMSTERDAM
The Netherlands
TELEPHONE +31 20 578 55 17
FAX +31 20 578 58 54
E-MAIL [redacted]
INTERNET www.loyensloeff.com

By mail and by e-mail
Autoriteit Consument & Markt
T.a.v. Mr. Chr. Fonteijn
Postbus 16326
2500BH Den Haag

EMAIL: [redacted]

FROM Roland de Vlam - Attorney-at-law/representative
REFERENCE 22408897 (70093174)
DATE 9 September 2016

RE Calculating the WACC for energy and water companies in Caribbean Netherlands
Opinion ContourGlobal Bonaire B.V.
Contains **confidential** business information

Sir,

I INTRODUCTION

1 On behalf of ContourGlobal Bonaire B.V. (**CGB**), I herewith submit (i) CGB's opinion (*zienswijze*) (i) on the "Calculating the WACC for energy and water companies in the Caribbean Netherlands" of August 2016 (the **Calculation**) including (ii) certain additional comments that relate to both the Calculation and the overall Draft Method ex. Art. 2.5(4) of the Electricity and Drinking Water Act BES (the **Draft Method**) now that has been provided to, and could be evaluated by, CBG in its entirety.

2 CGB refers to the extension of the deadline to 9 September 2016, as confirmed in the e-mail from Mr. Jörg of 5 September 2016 (16:19).

3 Reference is further made to CGB's earlier opinion of 14 August 2016 (the **Method Opinion**), on the Draft Method.

4 In this opinion, CGB concludes that the Calculation contains serious inconsistencies and flaws and is not suitable to be applied as proposed in the Method to determine the regulated production price.

5 To further illustrate and substantiate its opinion, CGB has engaged NERA Economic Consulting (**NERA**) as its economic adviser. NERA's findings (the **WACC Memo**) have

been attached to this opinion as **Annex 1** and must be considered an integral part of CGB's opinion. In addition, NERA has made a report on the regulatory framework in the Draft Method (**Method Memo**). This Method Memo is an integral part of CGB's opinion on the Draft Method and of this opinion. The Method Memo is attached hereto as **Annex 2**.[1]

II ASSUMPTIONS UNDERLYING THE CALCULATION

6 As a first remark, GCB would like to address the overall methodology applied by ACM in the Calculation. This methodology is based on the concept of opportunity costs:

> *The opportunity costs consist of the benefits that investors could have received if they had invested in an alternative (the second-best) portfolio of assets.*

7 On page 5/21 ACM states:

> *One consequence of the idea of opportunity costs is that we use the perspective of investors as the starting point when calculating the WACC.*

8 In other words, the ACM's focus is on an individual investor's perspective when investing in the Caribbean Netherlands. CGB disagrees with this approach. CGB is of the opinion that the return required by an investor in a particular asset is equal to the opportunity cost of investing in assets with the same risk. This reference to risk does not refer to the investor's perspective or location; rather it focuses on the return of the asset relative to assets with the same level of risk. As CGB has demonstrated in its Method Opinion, ACM's approach clearly is against the legislator's explicit objective in the legislative history.

9 In order to determine the reference capital markets and CGB's peer group, ACM makes three assumptions on page 5/21 that, according to CGB, are unjustified.

(i) First, ACM assumes that internationally active investors are (still) interested to invest in companies in the Caribbean Netherlands if these investments will improve the performance of their investment portfolios. While this assumption may be true in general in the past, it disregards the fact that international and Dutch investors are very reluctant today to invest in power production on the BES islands because of the imposed production price regulation. There is no reason anymore to assume that investing in the BES islands <u>today</u> will improve the performance of an investment portfolio.

[1] Both NERA memos are submitted subject to the exclusivity, confidentiality and limiting conditions as set out in the Method Memo.

(ii) Second, ACM assumes that investors want to have investments in the same region as the Caribbean Netherlands, including Latin America and the USA. From this assumption it follows that ACM is of the opinion that to investors it makes no difference whether the investment is on Bonaire, any given country in Latin America or the USA, as they are – according to ACM - part the same region. CGB denies that Latin America, USA and the Caribbean are one and the same region. It furthermore denies that this is a relevant factor in determining investment targets. It would imply that investors in South Korea would also be interested in investing in Japan or China, because they are in the same continent. This is of course not the case. As an example, ContourGlobal has invested in power plants around the globe, because of the specific characteristics of the respective plant and its business potential.

(iii) Third, ACM assumes that investors from Europe are possibly interested in investing in power production activities on Bonaire as the island is part of the Netherlands, as a result of which the entire European market would qualify as a reference market to determine opportunity costs. There really is no reason to assume that an investor (from any given European country) would be willing to invest in a price regulated production market on Bonaire, solely because Bonaire is part of the Netherlands. There is also no reason why this would apply more to European countries than other countries. Moreover, there is no reason to assume that the investor's home market (and the entire European continent) would qualify as a reference market.

10 It appears that the second assumption is based on the focus on the markets where the investment target is located, while the third assumption is based on the home market of the investor. ACM does not explain this difference in approach.

11 Instead of ACM's approach of selecting the markets in which investors may be located, a more theoretically sound approach is to determine a comparator market that resembles the risk profile of assets in the Caribbean Netherlands. These comparators face the same risk as that of the cash flows generated by an electricity production facility in the Caribbean Netherlands. ACM's choice of comparators does not take account of this regional risk on cash flows.

12 From the above, it follows that CGB strongly disagrees with ACM's conclusion that the capital markets in Latin America, USA and Europe can be defined together as the reference markets for determining the WACC of investments in the Caribbean Netherlands.

13 On page 6/21 (top) ACM furthermore without any substantiation states that there is no reason to apply a weight to the respective reference markets (regions) USA, Latin

America and Europe. This statement should at least be substantiated as it is may be an important factor in the Calculation.

14 In Chapter 3, on page 6/21, ACM states that the WACC gives the return that investors would achieve by investing both debt and equity in "similar projects in the market". As will be explained further below and in the WACC Memo, ACM has failed to do this in the Calculation. Instead of looking for 'similar projects in the market', ACM wrongly assumes that the country where investors are located is relevant rather than the country in which the investments are made. The definition of the capital markets in Latin America, USA and Europe as the reference markets for determining the WACC of investments in the Caribbean Netherlands is inherently wrong and contradictory to its objective to take into account 'similar projects in the market'.

15 In the WACC Memo, an alternative approach is proposed that is compliant and in accordance with economic theory.

III THE COMPOSITION OF THE PEER GROUP

16 In its Method Opinion (paragraphs 55 *et seq.*), CGB has already indicated its concerns regarding the peer group approach envisaged by ACM. In paragraphs 22 *et seq.* of the Method Opinion, CGB cited the relevant statements by the Minister of Economic Affairs (**MEA**) on the composition of the peer group to duly reflect the risk of investing on Bonaire and the need of a fair minimum return on investment. These concerns are reiterated here.

17 ACM has engaged Boer & Croon Corporate Finance (**BCCF**) to determine the peer group for CGB. On page 6 of its advisory report, BCCF sets out the theory behind the establishing of the peer group. According to BCCF a suitable peer group comprises of a number of listed companies which have similar cyclicality of revenues and operational leverage. BCCF concludes:

> *a business has a similar cyclicality of revenues when the business (to some extent):* ***(i)*** *Offers the same type of products/services,* ***(ii)*** *serves the same type of customers,* ***(iii)*** *faces the same level and type of competition* ***(iv)*** *operates in the same type of regulatory framework and* ***(v)*** *operates in similar economies/countries [...]*
>
> - *The type of cost structure/business model.*

18 On page 7 of its report, BCCF states that the most important criterion of the abovementioned is "the same type of products/services". According to BCCF:

adherence to this criterion generally also leads to similarities on other criteria such as the same type of customers, competition, cost structure and business model.

19 In this respect it should be noted that, by law, CGB has only one customer, WEB, who is the only designated distribution company on Bonaire. Although it is clear that producers of electricity provide the same type of products, this does not in all cases mean that they can be considered peers when they operate in different competitive circumstances with different types of customers.

20 The second most desirable criterion, according to BCCF, is "the same type of economies/countries". BCCF states in this respect:

this generally also leads to similarities in the type of customers, competition and regulatory framework.

21 BCCF (and ACM) have not substantiated how this second most desirable criterion has been applied to the reference markets selected. More particularly, it is not clear how the envisaged reference markets relate to the regulatory framework that is applicable to power production on Bonaire.

22 On pages 9 (bottom) and 10 (top) of its report, BCCF concludes that there are not many listed electricity companies that will be comparable to the characteristics of the Dutch Caribbean. This second most desirable criterion abandoned by BCCF when it claims:

Given the fact that a peer group has to comprise of approximately ten listed companies, BCCF decided to consider companies active in ***(i)*** *the Caribbean,*[2] ***(ii)*** *comparable islands and/or islands groups,*[3] ***(iii)*** *Europe,* ***(iv)*** *the United States and* ***(v)*** *Latin America.*

23 Apparently, BCCF has abandoned its second most desirable criterion, solely for the purpose of finding ten peer group companies with public listings. BCCF includes companies that are active in countries and regions that are far from comparable to Bonaire. Instead, BCCF, should have advised to compose a credible peer group and correct for the inherent shortcomings of that peer group. CGB refers to the WACC Memo, where a correct approach is set out.

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2 Including Netherlands Antilles, Cayman Islands, Dominican Republic, Jamaica, Bahamas, Cuba, Haiti, Trinidad and Tobago.

3 Including Hawaii, Canary Islands, Mauritius, Channel Islands, France Polynesia, the Açores and the Falkland Islands. BCCF fails to demonstrate why it considers these islands to be 'comparable'.

IV GEARING

24 On page 10/21 ACM chooses to adopt the median gearing of two different activities (combined power production and distribution, and combined water production and distribution) to use that gearing for production also. ACM states that this is justifiable because the medians of those two activities are both calculated as 0.42. However, this does not mean that for 'production only' activities the same median can be applied.

25 In the WACC Memo, NERA explains why this approach in unreliable and does not make use of the best available data. NERA concludes that for CGB a gearing of 66% should apply.

V COST OF EQUITY

V.1 Beta

26 With respect to the assessment of the Beta, CGB refers to chapter 4 of the WACC Memo of NERA.

27 In addition, CGB would like to point at an apparent typo in the numbers for CPFL in Table 11 on page 13/21. In CGB's view, the numbers for CPFL should be as follows:

	Equity Beta	Gearing (D/E)	Tax Rate	Asset Beta
CPFL Energias Renovaveis SA	0,42	1,04	33%	0,25

V.2 Risk-free rate, ERP and Regional Risk Premium

28 ACM calculates the ERP as the average of the ERP for Europe and the USA because Dimson, Marsh and Staunton do not report ERPs for countries or regions in Latin America. In CGB's view, using only Europe and USA, because Latin American data are not available, is not a robust approach and would lack a conceptual foundation.

29 Instead NERA suggests in the WACC Memo to use the risk-free rate and the ERP for the US and to adjust for regional risk of investing in an asset in the Caribbean Netherlands. NERA estimates risk-free rate of 2.24% to 2.73%, based on 10-year and 20-year maturity government bonds, compared to ACM's estimate of 2.77% and an ERP of 5.35%, compared to ACM's estimate of 5.11%.

30 In chapter 3 of the WACC Memo, NERA sets out the necessity of a Regional Risk Premium (**RRP**) and the manner in which such RRP should be calculated.

V.3 Adjustment for Asymmetric Risk

31 As ACM is aware,[4] the power plant operated by CGB is a very complex and state-of-the-art power plant combining and dispatching wind energy, HFO combustion and storage technologies. This type of power plant has an increased risk of technological obsolescence and machinery failure, resulting in greater asymmetric risk

32 Similarly, CGB is of the opinion that the small size of the power plant and the market which it serves heightens one-off asset stranding risks.

33 Since the CAPM applied by ACM does not capture these asymmetric risks associated with technological obsolescence and small size, CGB considers that the WACC should be adjusted to remunerate investors for this negative skewness in expected returns. In the WACC Memo, NERA sets out its estimate of an uplift to the asset beta to capture these risks.

VI COST OF DEBT

34 According to CGB, calculating the spread on corporate bonds is not realistic for this case. CGB's debt is project specific and can't be compared to a bond served by a diversified portfolio. This approach may be acceptable (under circumstances) in the tariff regulation of network operators who have a debt portfolio consisting of multiple loans with different conditions. However, as ACM is aware, CGB's plant is fully project financed for a period of fifteen year ending in 2025. This actual debt is more expensive than the theoretical debt calculated by ACM (and it would be even more expensive to break the current financing arrangements).

35 In chapter 5 of the WACC Memo, NERA points out that the use of actual debt costs to set the costs of debt is particularly appropriate in this case because the power plant on Bonaire has already been debt financed. Based on the factual situation, NERA calculates the cost of debt to be 6.76% based on data provided by CGB, compared to ACM's calculated average of 4.29%.

VII COMMENTS ON THE DRAFT METHOD – THE NERA METHOD MEMO

VII.1 Production costs as a formula?

36 In chapters 3.2 and 6 of the Method Memo, NERA advises that the ACM should define the "maximum production price" required by Article 2.5 (1) as a formula, rather than a value, to make it robust to changing conditions during a year. This formula would incorporate both a fixed charge and an energy charge, so that revenues vary in line with variations in CGB's costs.

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4 And has also been reported by Mazars.

VII.2 ACM adjustments

37 In section IV.3 of the Method Opinion, CGB commented on the discretion granted by ACM to itself to depart from the costs as shown in the accounts, without explaining how it will do so in accordance with its regulatory objectives and procedural criteria.

38 In the Method Memo, NERA concludes that any changes to accounting costs should conform to ACM's objective of investor protection (by establishing the remaining value that would be recovered under the PPA) and should not infringe the objective of consumer protection by imposing arbitrary adjustments that raise the cost of capital and increase prices for consumers.

39 As an example, the following should be taken into account. Pursuant to article 2.4 of the PPA between CGB and WEB, upon expiry of the PPA in 2025, WEB is entitled to purchase the shares in CGB against a strike price that is determined on the basis of an agreed depreciation ratio in 15 years, i.e. until 2025. This means that the asset base of the project will decline rapidly. At the same time the debt service will increase pursuant to the agreed repayment schedule with Rabobank.

40 In order to preserve the project ACM should set a RAB that gives depreciation and a return high enough to cover CGB's remaining debt repayments and other financial commitments. Clearly, it is ACM's responsibility to ascertain that any value it ascribes to the RAB is consistent with CGB's future cash flow requirements, in order to *protect investors.* Alternatively an annuity system could be put in place to that same effect.

VII.3 Costs of inflation

41 In paragraph 76 of the Draft Method, ACM will take account of inflation by increasing costs by the rate of inflation on the islands.

42 In the Method Memo, NERA notes that the Draft Method does not specify whether the ACM will in practice use Dutch (Euro) inflation, a (US dollar) inflation index for the US or for the Dutch Caribbean, or an index constructed specifically for Bonaire. CGB submits that ACM would only comply with its objective of investor protection if it applies the index which most closely tracks CGB's efficient costs.

VII.4 Passing-through of costs

43 In paragraphs 72 *et seq* of the Draft Method, ACM provides an overview of how profit-sharing might work in practice to convert costs into revenue.

44 In this respect CGB, refers to chapter 4 of the Method Memo.

45 In summary, CGB submits that:

(i) ACM's approach only works for costs which are expected to rise steadily in line with general inflation. The approach performs poorly for costs that are rising faster (or more slowly) than inflation, and for exceptional/extraordinary costs (i.e. special one-off costs) that are not expected to be repeated in every subsequent year.

(ii) The ACM states that it "may" take companies' forecasts of rising or falling costs "into account" when setting revenue allowances, but not how it will do this. It provides no reassurance that unexpected costs (e.g. the cost of repairing a major fault) will be treated in the same way *ex post*. ACM has also made no commitment to apply the cost of capital to any delay in recovering such costs.

46 In order to avoid injecting unnecessary regulatory risk and raising the cost of capital, the Method should at the very least provide for methods (calculations) and/or principles (guidance) to be applied to such costs, such as:

(i) Whether the treatment applies only to forecast costs, or also to unexpected costs already incurred;

(ii) How to identify the costs that require this treatment (i.e. which costs that deviate from a trend);

(iii) What information is required to back up a request for recovery of such costs (e.g. signed contracts for future expenditures, invoices for similar costs in the past, evidence of the non-recurrent nature of such costs);

(iv) Pass-through rules for such costs, including the timing of pass-through and the scope for any *ex post* adjustments when actual costs become known.

VII.5 Pass-through rate - 50/50 ratio

47 In section IV.2.5 of its Method Opinion, CGB made initial comments on the 50 percent profit sharing as opted for by ACM.

48 In the Method Memo, NERA concludes that the Draft Method uses a 50 per cent profit sharing factor for illustrative purposes, but does not provide any justification for using this figure, or any particular figure. NERA comments that this approach to decision-making is not consistent with the need for *transparency*, and this particular value may produce profit outcomes that are inconsistent with *consumer protection* or *investor protection.*

49 In an appendix to the Method Memo, NERA has provided worked examples of ACM's approach to profit sharing for five different paths of CGB's possible future costs. On the basis of these examples NERA comes to the following conclusions:

- *The ACM's approach may offer a relatively weak incentive for cost reduction, because ContourGlobal will only keep half the cost reduction for a single year, while consumers capture most of the lasting benefit.*
- *The ACM concludes that a 3-year price control is the appropriate length for the initial regulatory period. However, it is not clear how ACM will set costs at the beginning of the price Control. A change in the method may strand some efficiently-incurred costs, particularly if costs are volatile.*
- *If costs are volatile, or increasing over time, the impact on year-on-year cash-flows could be substantial which may cause financing difficulties for CGB.*

50 These examples indicate that a profit-sharing scheme with a high incentive rate may offer limited benefits for short-term efficiency. However, wide variations in profit would create additional problems for long-term efficiency, by raising CGB's cost of capital. CGB submits that the design of the profit-sharing scheme should allow CGB to retain access to low cost capital, by limiting risks to CGB's profits and cash flow.

VII.6 Statutory tasks

51 In section III.2 of the Method Opinion, CGB already discussed the broader scope of the statutory tasks than currently under the concession and the PPA. To give you a clear example of the concerns, CGB refers to article 2.3(1)(b) of the Act, which provides that the producer has been assigned with the task to guarantee sufficient production capacity to meet demand without disruptions (*zonder verstoringen*). CGB's concern is that this statutory requirement may be explained as a requirement for a producer to maintain an n-1 redundancy (or even n-2 during planned and unplanned maintenance). Clearly, this is not how the plant has been designed as this was never a requirement. However, if this statutory requirement is in fact applicable, this will have an impact on the entire operation and the Method should take this into account.

52 The task of maintaining sufficient production capacity to meet demand imposes on CGB an obligation to construct additional capacity, as and when demand rises above its existing capacity. CGB will only be able to fulfil such obligations if it can attract capital for new investment. To make this feasible, the allowed rate of return must cover CGB's cost of capital. To preserve efficiency, the regulatory regime must keep down CGB's cost of capital. To maintain a low cost of capital, the regulatory regime must minimise unnecessary risks, in particular by preserving CGB's ability to fulfil its debt covenants. To fulfil these covenants, CGB has to maintain certain levels of profit or cash.

53 This new and additional task therefore reinforces the need for the new regulatory regime to take into account CGB's need for a minimum level of profit and cash flow. CGB would welcome an opportunity to present these commercial requirements to the ACM and to discuss how the regulatory regime might best accommodate them.

VII.7 Indirect effects of price regulation on the project

54 As last remark, CGB would like to stress that setting the maximum regulated production price does not only have an impact on the Energy Charge calculated under the PPA. In fact it will influence all commercial aspects of the entire project, including debt service, the economics against the duration of the PPA, maintenance obligations, etc. An adequate price regulation must take into account the project as a whole (as the basis for the non-recourse project finance) including the PPA, not only the price that will be charged to WEB.

VIII CONCLUSIVE REMARKS

55 In view of the above, CGB urges ACM to reconsider the Calculation and to establish a new WACC Calculation that sufficiently takes into account the relevant production activities of CGB. In addition, CGB submits that ACM should investigate and take into account the desirability of CGB maintaining minimum levels of profit and cash flow, and the implications for the cost of capital and the regulatory regime as a whole. CGB will provide you with all additional information necessary.

Please do not hesitate to contact me should you have any questions.

[redacted]

Yours sincerely,
Loyens & Loeff N.V.

[redacted]

Roland de Vlam

[redacted]