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8 December 2022

Dear stakeholder,

CEPA report on aspects of the cost of capital Input Methodologies for the 2023 review

Purpose of this letter

1. The purpose of this letter is to invite submissions on the report by Cambridge Economic Policy Associates Pty Ltd (**CEPA**) on aspects of the cost of capital input methodologies.[1] We commissioned the report as part of our 2023 review of the input methodologies that underpin the Commission's regulation of airport services, electricity lines services, and gas pipeline services.[2]

What CEPA was asked to do

2. We asked CEPA to provide us with updated estimates in three areas.

- Asset Beta and leverage: CEPA was asked to apply the method we used in the last review of the input methodologies in 2016 (**2016 IM review**), with updated data, to identify a set of businesses that are suitable comparators for airport services, for electricity lines services, and for gas pipeline services. CEPA was asked to use this updated comparator sample to calculate estimates of asset beta and leverage.[3]

- WACC Percentile: CEPA was asked to implement our 2014 methodology for considering the appropriate WACC percentile for price-quality regulated energy businesses.[4]

[1] CEPA "Review of Cost of Capital 2022/2023 – New Zealand Commerce Commission" (29 November 2022).

[2] The background to the review is set out in the Notice of Intention: Commerce Commission "Notice of Intention: Input Methodologies Review 2023" (23 February 2022).

[3] Commerce Commission "Input methodologies review decisions: Topic paper 4: Cost of capital issues" (20 December 2016), para 266-489.

[4] Commerce Commission "Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services: Reasons paper" (30 October 2014).

- Credit rating: CEPA was asked to provide information on credit rating for firms in the asset beta comparator samples using the approach taken in the 2016 IM review.[5]

Specific matters we would like your views on

3. We have identified some specific matters relevant to CEPA's report that we will be considering further as we prepare our draft decision, and we would welcome your views on these matters.

Asset Betas

4. In relation to our calculation of asset beta, at the last review we focussed on asset betas from the two most recent five-year periods (2006-2011 and 2011-2016); however, we also had regard to earlier periods. The economic consequences of COVID have resulted in an increase in asset betas for airport services, as indicated in CEPA's calculation of the average asset beta for the 2020-22 period compared to the average asset beta for the periods 2012-2017 and 2017-2022. We are considering whether we should use a term for airports that is either longer or shorter than the last two five-year periods. For energy, CEPA's findings indicate there does not appear to be a need to vary the sampling timing we used last time; however, we welcome views on this.

5. At the last review, the energy comparator sample included companies from New Zealand, Australia, United States, and United Kingdom. The comparator sample identified by CEPA for this review is now largely a sample of businesses from the United States. We are considering whether we should continue to use companies from Australia that have been recently delisted, and whether we should provide weightings to countries to reduce the weighting of companies from the United States in the comparator sample. We are also considering whether airport companies that have recently been delisted should be included in the comparator sample.

6. We previously created a comparator sample for energy businesses that did not distinguish between electricity and gas services. However, we made an upward adjustment of 0.05 to the asset beta for the gas pipeline businesses because we considered gas has a higher income elasticity of demand than electricity and the risk of stranding of the gas pipeline assets is higher in New Zealand relative to the companies in the comparator sample. In this review, we are considering whether to split the energy comparator sample into gas and electricity. We note CEPA's finding that while the average asset beta for gas is higher than for electricity, the difference between the two estimates is not statistically significant.

7. For the calculation of the asset beta for airports, we are considering whether to continue to apply a downward adjustment to the average asset beta from the comparator sample. At the last review, we concluded that the average asset beta from the comparator

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5 Commerce Commission "Input methodologies review decisions: Topic paper 4: Cost of capital issues" (20 December 2016), para 250-257.

sample was likely to overstate the beta for regulated aeronautical activities. We came to this conclusion because the companies in the sample generally had a mix of aeronautical and non-aeronautical activities, and we considered the asset beta for aeronautical services was likely to be lower than the asset beta for non-aeronautical services.

8. We are also considering whether some airport companies identified by CEPA should be excluded from the comparator sample on the basis that the markets in which they operate are substantially different to the New Zealand market. For example, we are considering whether we should exclude companies from countries that have a market risk premium that is substantially different to the market risk premium for New Zealand. We are also considering whether we should exclude companies that have a large variance in estimates based on daily, weekly and four-weekly data. We are concerned that companies that do not have a stable estimate of asset beta may not be suitable comparators.

WACC Percentile

9. In relation to the WACC percentile, we asked CEPA to apply the methodology we developed in 2014 and used in developing the fibre IMs in 2020.[6] We would welcome views on two specific points. First, when we first set the WACC at the 67th percentile for price-quality regulated energy businesses, the justification for the uplift was developed solely with reference to electricity distribution and transmission and the cost of electricity blackouts. We welcome views on whether we should continue to apply an uplift to price-quality regulated gas businesses. Second, the most important change to the wider energy economy since 2016 is the expectation of increased electrification of the economy as part of the response to climate change. We welcome views on how the increased electrification of the economy impacts our reasoning around the costs of blackouts and our methodology for considering whether a WACC uplift is warranted.

Our methods when updating the cost of capital estimates

10. We did not ask CEPA to advise on whether we should continue using our past methods when updating the cost of capital estimates. However, when submitting on the CEPA report, stakeholders may wish to raise issues relating to the methods we should use to calculate asset beta, leverage, credit rating, and for determining the appropriate WACC percentile for price-quality regulated energy businesses.

Other aspects of cost of capital

11. We acknowledge that there are other parts of the regulatory regime which relate to the cost of capital which are being considered as part of the IM review. Accordingly, we take

[6] *Ibid.* and Commerce Commission "Fibre Input Methodologies Determination 2020" (21 December 2021), para 6.642-6.873.

this opportunity to invite submissions and expert reports on all topics relating to the cost of capital.

Providing your submission

12. We welcome submissions by **5pm on Friday 03 February 2023**.

13. In inviting submissions, we draw attention to our decision-making framework for the review. We will consider your views through the lens of the decision-making framework and evaluate them against the decision criteria.[7]

Responses should be emailed to:

Geoff Brooke, Senior Economist.

c/o im.review@comcom.govt.nz;

'2023 WACC review' in the subject line of your email.

Confidentiality

14. When including commercially sensitive or confidential information in your submission:

    14.1 please provide a clearly labelled confidential version and public version. We intend to publish all public versions on our website; and

    14.2 the responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

15. Please also note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we do not publish unless good reason existed under the Official Information Act 1982 to withhold it. We would normally consult with the party that provided the information before any disclosure is made.

Yours sincerely

Charlotte Reed
Input Methodologies Manager
Infrastructure Regulation
Commerce Commission

[7] Commerce Commission "Part 4 Input Methodologies Review 2023: Framework paper" (13 October 2022).