3 February 2023

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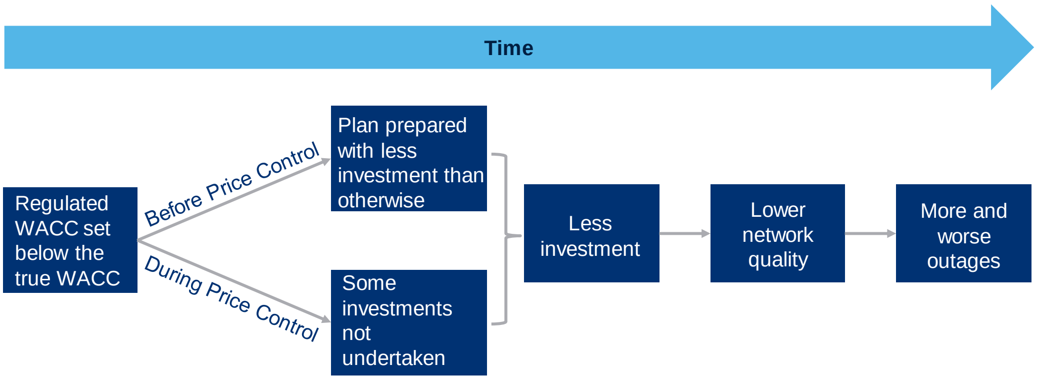
Via email im.review@comcom.govt.nz

Tēnā koutou,

The review of the cost of capital IM is an opportunity to ensure incentives for infrastructure investment support the impacts of customer and industry decarbonisation

This review of aspects of the cost of capital input methodologies will shape industry investment in decarbonisation and electrification infrastructure for decades. Powerco is one of Aotearoa's largest gas and electricity distributors, supplying around 340,000 (electricity) and 112,000 (gas) urban and rural homes and businesses in the North Island. These energy networks provide essential services and will be core to Aotearoa achieving a net-zero economy in 2050. An appropriate cost of capital allowance will enable networks to deliver these services and continue to support customer choices about their energy needs as New Zealand's energy sector decarbonises.

Networks have a crucial role enabling New Zealand's decarbonisation journey while maintaining reliable supply almost all New Zealanders. The cost of capital settings are a core part of the regulatory framework that supports the investment needed to achieve this. The Commission's consultation considers several of the weighted-average cost of capital (WACC) settings used to *estimate* the true WACC faced by distributors. Our views on the Commission's consultation are informed by expert reports from Oxera that we have co-commissioned with other electricity and gas network businesses. Oxera observe that a regulated WACC below the true WACC creates incentives to propose and undertake fewer investments, reducing network reliability. The impact on consumers is asymmetric when balancing the costs of setting a WACC too low against the social costs of unreliability.



Source: Oxera

For this 2023 Input Methodologies review, a paired back 'what's changed?' approach has been taken, with the Commission seeking feedback on a report from CEPA on a subset of the WACC inputs. A relatively short engagement/consultation process has been used too. We support this approach and have scaled our response proportionately. We note that this differs from the 2016 Input Methodologies review of cost of capital which was comprehensive, with considerable input and debate from experts to inform the Commission's final decision.

Our submission[1] on the IM review 'process and Issues' paper[2] commented that the IMs (and application in each DPP reset process) need mechanisms that:

- Support electricity distributors meet the long-term individual and collective customer needs from electrification
- Support gas distributor long-term investment and operation required to support a transition off natural gas

WACC settings are part of the regulatory system that enable these outcomes. A theme of Oxera's reports is that that regulatory stability and minimised network disruption are essential aspects of the pathway to decarbonisation. In that context, our views on the WACC settings raised by the Commission are:

WACC percentile	• Maintain an uplift on the WACC percentile at or above the 67th percentile for electricity networks, given the costs of underinvestment are heightened in an environment of accelerated electrification • Maintain an uplift of WACC percentile at or above 67th percentile for gas networks to preserve incentives to invest in secure and reliable gas networks to ensure an orderly energy transition
Asset beta and leverage	• Maintain combined energy comparator sample due to nature of energy businesses in New Zealand • Maintain uplift of asset beta for gas networks given heightened risk (consistent with 2016 IM decisions paper[3]

Attachment 1 contains more commentary about how we arrived at these views, and references reports from Oxera submitted jointly with other networks. If you have any questions regarding this submission or would like to talk further on the points we have raised above, please contact Jeremy.Smith@powerco.co.nz.

Nāku noa, nā,

[redacted]

Andrew Kerr
Head of Policy, Regulation, and Markets
POWERCO

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[1] https://comcom.govt.nz/__data/assets/pdf_file/0023/288014/Powerco-Submission-on-IM-Review-Process-and-Issues-paper-and-draft-Framework-paper-11-July-2022.pdf

[2] https://comcom.govt.nz/__data/assets/pdf_file/0031/283864/Part-4-Input-Methodologies-Review-2023-Process-and-Issues-paper-20-May-2022.pdf

[3] https://comcom.govt.nz/__data/assets/pdf_file/0021/60537/Input-methodologies-review-decisions-Topic-paper-4-Cost-of-capital-issues-20-December-2016.pdf

Attachment 1. Response to CEPA report

The Commission has invited submissions on the report by Cambridge Economic Policy Associates Pty Ltd (CEPA) on aspects of the cost of capital input methodologies[4]. The report is part of the 2023 review of the input methodologies that underpin the Commission's regulation of airport services, electricity lines services, and gas pipeline services[5].

The Commission listed the issues from CEPA's report that will be considered for preparation of the draft decision. We've summarised these as:

1. **Asset beta comparator sample** - should the Commission continue to use companies from Australia that have been recently delisted, and should we provide weightings to countries to reduce the weighting of companies from the United States in the comparator sample (as these make up the majority).
2. **Gas asset beta** – the Commission are considering whether to split the energy comparator sample into gas and electricity and whether the uplift of Gas asset beta is still justified?
3. **WACC percentile** – given that the justification for the uplift of WACC percentile was developed solely with reference to electricity distribution and transmission and the cost of electricity blackouts, should we continue to apply an uplift for gas businesses. How does increased electrification of the economy impact the Commission's reasoning around cost of blackouts and methodology for considering whether a WACC uplift is warranted?

Our submission is informed by evidence from expert reports we have co-commissioned with gas and electricity network companies. Powerco own and operate both electricity and gas networks and our submission covers both of these services. For ease of reading these two areas have been separated into sections.

Electricity Lines Services

Powerco supports the findings outlined in the CEPA report, specifically Powerco's view is that:

- The increased electrification of the economy since the 2016 review, as part of the response to climate change, amplifies the cost and risk of underinvestment. CEPA outlines the cost of network failure has increased by nearly \$1bn (\$1bn to 1.9bn) as a proxy of change in GDP and value of lost load in New Zealand. The net social benefit of setting the WACC percentile above the midpoint has also increased to a range of \$80-200m at the 70th percentile.
- In reference to the UKRN recommendation outlined in the report, it states "regulators should only deviate from the midpoint…if there are strong reasons to do so[6]." Rising costs of network failure and net social benefits of a WACC percentile above midpoint are strong reasons to increase from the midpoint with an uplift.
- Use of an updated comparator sample for the calculation of asset beta and leverage.
- Use of an updated single leverage metric across EDBs and GPBs.
- Setting the nominal credit rating at BBB+ for EDBs and GPBs

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[4] CEPA "Review of Cost of Capital 2022/2023 - New Zealand Commerce Commission" (29 November 2022)

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

[6] UKRN, UKRN guidance for regulators on the methodology for setting the cost of capital – consultation

Two reports by Oxera[7] have been prepared on behalf of the 'Big 6' EDBs, which cover the IM review cost of capital issues relating to Electricity Lines Services. The key conclusions relating to the issues raised in the CEPA report are:

- The regulatory approach to reliability supports targeting a percentile between the 65th and 85th percentiles of the WACC distribution based on their assessment of the socio-economic benefits of aiming up on the WACC percentile.
- The Commission has not found evidence of overcompensation due to a 67th percentile WACC, rather it has published evidence they have been under-compensated. This shows customers have not faced unduly high costs.
- Gives weight to the need to maintain regulatory stability, this supports the retention of at least the 67th WACC percentile.
- Improvements can be made in selecting the most appropriate companies for the comparator sample used for asset beta and leverage.

We also draw attention to other cost of capital issues raised in these two reports.

- Risk-free rate - currently, the Commission estimates this rate by observing yields on 5-year NZ government bonds for 3 months of the most recent data. Oxera recommends the Commission should adjust its method to reflect a wider range of government bonds from 5-20 years. This is supported by regulatory precedent and reflects the varying time horizons of network investments. Some European regulators have applied an uplift to the risk-free rate estimates to reflect the safety and liquidity characteristics of government bonds.
- Indexing - proposal that the risk-free rate and cost of debt should be indexed to reduce the risk of exposure from market movement in interest rates during the regulatory period. In the current high inflationary period, there is increase in volatility and would align with Ofgem and AER practises.
- Financeability – recommends that the Commission add a financeability assessment to the regulatory process as the AER and Ofgem do. This would ensure EDBs receive sufficient funding for decarbonisation and increased electrification. This assessment could be made on a notional basis by analysing market information on the actual capital structure of EDBs. These metrics would ensure EDBs satisfy a minimum credit rating.

We support the ENA's submission, in particular:

- Issues relating to the WACC percentile, including the impact of higher growth and uncertainty on the WACC percentile, as well as the impact of the evolving role of EDBs. Both require support for growth in investment levels for EDBs.
- Issues relating to comparator sample selection for asset beta and leverage.

WACC is part of the package of settings that influence network investment. Just as important is the process for setting appropriate allowances for opex and capex to support decarbonisation. This is a separate process the Commission will undertake during reset of the Default Price-quality path.

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[7] Oxera "Review of the NZCC's WACC-setting methodology" and "Review of the percentile of the WACC distribution that should be targeted by the NZCC"– commissioned by the "Big 6" EDBs

Gas Pipeline Services

Powerco supports the findings outlined in the CEPA report, specifically Powerco's view is that:

- The Commission should continue to apply an uplift of WACC percentile to price-quality regulated gas businesses. Gas has an important security of supply role during the energy transition to decarbonisation, helping to minimise electricity blackouts, and with higher income elasticity of demand[8].
- In reference to the UKRN recommendation outlined in the report, it states "regulators should only deviate from the midpoint…if there are strong reasons to do so[9]." Rising costs of network failure and net social benefits of a WACC percentile above midpoint are strong reasons to increase from the midpoint with an uplift.
- The Commission continue to apply an uplift of asset beta for Gas given the CEPA evidence of a gas asset beta of at least 0.5-0.9 higher than the energy sample.
- Powerco supports the use of an updated single leverage metric across EDBs and GPBs.
- Powerco supports setting the nominal credit rating at BBB+ for EDBs and GPBs

A report by Oxera[10] has been prepared on behalf of the GPBs which covers the IM review cost of capital issues relating to Gas Pipelines. The key conclusions relating to the issues raised in the CEPA report are:

- There is empirical and theoretical evidence supporting the upward adjustment of Gas asset beta when compared to electricity.
- Improvements can be made in selecting the most appropriate companies for the comparator sample used for asset beta and leverage.
- There is both academic and regulatory precedent support for aiming up on WACC percentile as well as regulatory stability.
- There does not appear to be a clear case for changing the way gas network reliability is incentivised in New Zealand as WACC uplift does not seem to be causing excess profits based on the Commission's analysis.
- The cost of network failures has increased, and it could be difficult to reverse the impact of underinvestment.

[8] Detailed in 2016 IM review submissions

[9] UKRN, UKRN guidance for regulators on the methodology for setting the cost of capital – consultation

[10] Oxera "Asset beta and WACC percentile for New Zealand gas distribution businesses" - commissioned by GPBs