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**Cross-submission to the Commerce
Commission in response to the
Commission's expert reports on the
cost of capital for the UCLL and
UBA price reviews**

AND

**Submission on the Part 4 review of
WACC uplift**

4 August 2014

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Executive Summary

1. This cross-submission deals also with the Commission's Part 4 WACC draft decision and related consultation material announced the day after the UBA and UCLL submissions were due. The cross-submission has been prepared by Rob Allen and Michael Wigley.
2. The establishment of the appropriate WACC is a key part of the determination of the TSLRIC prices for UCLL and UBA. Get it wrong and the prices for UCLL and UBA and, ultimately, end-user retail prices will be too high (or too low but that looks unlikely on the current approach). It will also compound any errors in determining the value of a MEA-based network, if that is also inflated.
3. It is apparent from submissions that the key risks are:
 - a. Failure to recognise the difference between Chorus and a hypothetical efficient operator;
 - b. Over-reliance on Chorus' operations as a data point;
 - c. Incorrect application of s 18;
 - d. There are continuing indications that this process is still being undertaken too quickly and with insufficient evidence; that leads to a highly material bias toward increasing the WACC and therefore prices;
 - e. Deviation from Part 4 WACC IMs without proper pan-industry consultation and decision-making, taking into account the overlaps and the differences between Part 4 WACC and UBA/UCLL WACC; and
 - f. Failure to recognise that there are fundamental differences between price regulation of copper and of electricity under Part 4 of the Commerce Act that mean the proposed electricity WACC percentile will be too high for copper.
4. On the latter point we are essentially treating the Commission's Part 4 WACC percentile consultation material as an input into the determination of WACC for UCLL and UBA services.

Hypothetical efficient Operator is not Chorus

5. We agree with Telecom and Network Strategies that "the relevant reference point is a hypothetical efficient provider of UCLL / UBA services, not the regulated entity".¹
6. It should be recognised that while the Commission is basing its UCLL and UBA WACC determinations on the Part 4 WACC IMs a key difference between Part 4 of the Commerce Act and Part 2 of the Telecommunications Act is that the Commission's role is to determine the costs of the regulated supplier under the Commerce Act and the costs of a hypothetical efficient operator (not the regulated supplier, Chorus) under the Telecommunications Act.
7. An implication of the distinction between Chorus and a hypothetical efficient operator is that, as pointed out by Network Strategies, "Consistent with overseas regulatory practice, ... a true forward-looking approach would not take into account historic debt associated with existing

¹ Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014, page 1.

assets, but would consider only the efficient issue of new debt”,² and that Chorus’ actual credit rating should not be given primary weight, no adjustments to the cost of debt should be made based on Chorus’ actual debt holdings, etc.³

Oxera confuse calculation of Chorus’ WACC and that of a hypothetical efficient operator

8. A concern we have with the Oxera report, confirmed by the PricewaterhouseCoopers and Network Strategies’ reviews, is that Oxera appear to be more focused on determining the WACC input values for Chorus rather than that of a hypothetical efficient operator. While Oxera acknowledge the need to model for a hypothetical operator, the reality is that the modelling is all but fully based on Chorus and its unique circumstances, as opposed to those of a hypothetical operator.
9. We agree with PricewaterhouseCoopers that while Oxera conclude “Statistical testing suggests that the observable Chorus beta is robust for use in estimating the equity beta for UCLL and UBA”⁴ it is unclear how this could be the case, given the limited history as a listed company, the significant instability (downwards) in its share price (related to Commerce Commission pricing determinations) and the substantial difference between Chorus and a hypothetical efficient service provider.

Dr Lally rightly rejects most of Chorus’ attempts to seek a higher WACC

10. Dr Lally is right to reject CEG’s attempts to have the WACC determination inflated. We support Dr Lally’s arguments for dismissing CEG’s proposals, and the related arguments by Telecom and Network Strategies in support of Dr Lally’s views.
11. To ensure consistency across industries and between the Commerce Act and Telecommunications Act, we consider that the Commission should only consider deviation from the Part 4 IMs if it does so in conjunction with review of whether the Part 4 WACC IMs should also be amended. This would be highly relevant to the Commission’s Transpower IPP and electricity distribution DPP 2015 price reset processes which it is currently conducting.

Incorrect application of s 18?

12. The experts’ reports do not deal directly with s 18. However:
 - a. Oxera for example identify the need for consistency with the risks associated with investment in services similar to those offered by Chorus;
 - b. For reasons to be identified this week in the FPP submissions (on which this cross-submission relies, and already identified in CallPlus and Orcon WACC submissions), the approach to WACC in papers thus far from the Commission has an application of s 18 beyond what the Act permits.
13. The choices being addressed in the reports – and as to percentile choices - ultimately fall to be determined by cost evidence, unless and until a plausible range at a decision point is reached. Only then can s 18 be used to help guide the choice from the plausible range.
14. This for example is a critical point to address when applying the IM WACC percentile approach to the UBA and UCLL WACC calculation.

² Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014, pages 1 and 2.

³ Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014, page 26.

⁴ Oxera, Review of the beta and gearing for UCLL and UBA services: Evidence and recommendations, June 2014, page 21.

Process still being undertaken too quickly

15. Oxera has defaulted to using “Chorus’ beta as a focal point for our analysis”.⁵ Even in their attempt to identify comparators, the unique position of Chorus as a separated entity, relative to vertically integrated Telcos, is singled out to show why those comparators are not directly comparable. Lost in that process is the hypothetical operator.
16. This is likely to result in part due to one or more of the following causes that arise from undue haste:
 - a. Scoping of the work of Oxera, in its instructions, so that Chorus data is used in this way, so that Chorus ends up dominating the assessment (for example as that is the quickest approach and/or the cheapest approach);
 - b. Oxera doing its report on that basis, with the problems not removed on review of their draft;
 - c. The classic problem that speed dictates use of the incumbents’ data, and not a proper assessment of a hypothetical efficient operator.
17. We refer to concerns to be identified in the FPP submissions this week, to expand on this general concern. Essentially, WACC is an example of the wider problem.
18. There is a related facet of this issue. As has been identified in earlier submissions by CallPlus and Orcon in this process, and will be further developed in this week’s FPP submission (on which this submission relies), decisions on the path to estimating WACC must, according to court authority, be sufficiently evidence based. By relying on the wrong evidence and/or by not sufficiently using non-Chorus evidence, the Oxera report, for example, may not meet this threshold requirement. The same applies to other WACC decisions such as the percentile choice. For example, the Part 4 approach in the latest draft decision as to percentile choice, which was driven by the High Court IM criticisms as to lack of evidence, is considerably more detailed than the approach thus far for the UBA and UCLL IPPs.

Interrelationship with Part 4 of the Commerce Act

19. If the Commission considers adopting an approach which is inconsistent with the Part 4 WACC IMs, for any generic WACC matters, it should also review the WACC IMs in parallel.
20. It is quite clear, from reading various WACC submissions under Part 2 of the Telecommunications Act and Part 4 of the Commerce Act, that there are cross-sectorial matters the Commission should take into account in its WACC decisions. Most notably in relation to the WACC percentile selected.
21. The Commission has stated that the WACC IM processes and UBA/UCLL processes “should operate separately” and “except where we expressly say otherwise, we will not have regard to submissions from: ... the cost of capital IMs process in the UCLL and UBA processes; and ... the UCLL and UBA processes in the cost of capital IMs process”.⁶ It is not clear just how separate the two processes would be but the impression is one of keeping them largely unrelated. There are differences, but the overlaps are substantial and there is risk of error, and inefficiency, if they are not handled in parallel. There are practical ways to achieve this, while meeting the differing

⁵ Oxera, Review of the beta and gearing for UCLL and UBA services: Evidence and recommendations, June 2014, page 2.

⁶ Commerce Commission, Further work on cost of capital input methodologies: Process update, 23 June 2014, paragraph 13.

Part 2 and Part 4 objectives.

22. The Commission's draft decision to select 67th percentile WACC for energy sets a ceiling for the WACC percentile for UCLL and UBA services. We are of the view that the optimal WACC percentile for UCLL and UBA services is substantially lower than for energy utilities, and could be below mid-point. Dobbs' 42th percentile for sunk costs provides the most relevant assessment of the appropriate WACC percentile for UCLL and UBA services that has been provided so far.

Introduction

1. We are responding to submissions made in relation to the Commerce Commission's expert reports on the cost of capital for the UCLL and UBA TSLRIC FPP price determinations:
 - a. Dr Martin Lally, Review of submissions on the cost of debt and TAMRP for UCLL and UBA services, 13 June 2014; and
 - b. OXERA, Review of the beta and gearing for UCLL and UBA services: Evidence and recommendations, June 2014.
2. This cross-submission also comments on, and should be treated as a submission in relation to, the Commission's consultation paper "Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services", 22 July 2014. The WACC percentile consultation paper, and related expert reports, effectively brings in new and highly material matters into the debate over the setting of WACC for UCLL and UBA services. Contrary to the Commission view, we think the two processes are integrally tied up. The WACC percentile consultation material effectively places a new, lower, ceiling on the WACC for UCLL and UBA services, as well as evidence to support a below mid-point WACC.
3. Based on the amount of material provided by the Commission as part of its consideration of the appropriate WACC percentile for energy, and that the Commission has not considered the matter in the specific context of UCLL and UBA services, a decision on the WACC percentile for UCLL and UBA services may not be a trivial matter. We say this conscious of the very tight deadlines the Commission has set itself for completion of the TSLRIC price determinations for UCLL and UBA services. We trust the comments we provide below will assist the Commission in its process.
4. We thank the Commission for the opportunity to cross-submit. Our cross-submission is not confidential.

Observations in relation to the submissions on the Oxera and Lally reports

5. We agree with Telecom that “if the Commission is properly to implement a TSLRIC model as envisaged by the legislation” the appropriate benchmark is that “of a hypothetical efficient provider of UCLL and UBA services”.⁷ Similarly, Network Strategies comment that “the relevant reference point is a hypothetical efficient provider of UCLL / UBA services, not the regulated entity”.⁸
6. An implication of the distinction between Chorus and a hypothetical efficient operator is that, as pointed out by Network Strategies, “Consistent with overseas regulatory practice, we consider that a true forward-looking approach would not take into account historic debt associated with existing assets, but would consider only the efficient issue of new debt”,⁹ and that Chorus’ actual credit rating should not be given primary weight, no adjustments to the cost of debt should be made based on Chorus’ actual debt holdings, etc.¹⁰
7. Chorus’ submissions, and that of their advisors, fail to recognise the distinction between itself and a hypothetical efficient operator. This has been a common theme of Chorus’ TSLRIC submissions which have advocated modelling the cost of providing UCLL and UBA services on Chorus’ actual network and actual costs (or as closely as possible). For example, Chorus’ asserts that “This consultation on a ... WACC ... for Chorus, for the first time, enables investor returns to be set at the level which properly reflects the risk profile of Chorus’ business”.¹¹
8. A concern we have, confirmed by the PricewaterhouseCoopers¹² and Network Strategies’¹³ reviews of the Oxera report, is that the Oxera report is also more focused on determining the WACC input values for Chorus than that of a hypothetical efficient operator.

Oxera appear to be calculating the WACC of Chorus and are over-reliant on Chorus’ data

9. We share the concerns expressed by Network Strategies and PricewaterhouseCoopers that the Oxera report places heavy reliance on Chorus’ equity beta.
10. This raises a number of issues:
 - a. The report is overly reliant on one data source (Chorus). This makes the equity beta estimate subject to a large degree of estimation error.
 - b. Chorus has only existed as a separate listed company for two and a half years, which limits the available Chorus data. This makes the estimate of Chorus’ equity beta vulnerable to one-off events that impact on Chorus (such as its purported financial difficulties, and the impact of the Commerce Commission pricing determinations) or the

⁷ Telecom, Expert reports on the cost of capital for UCLL and UBA price review”, 21 July 2014, paragraph 10.

⁸ Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014, page 1.

⁹ Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014, pages 1 and 2.

¹⁰ Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014, page 26.

¹¹ Chorus, Submission in response to the Commission’s expert reports on the cost of capital for the UCLL and UBA price reviews, 21 July 2013 [sic], paragraph 2.

¹² PricewaterhouseCoopers, Submission on the Commerce Commission Expert’s paper: Review of the beta and gearing for UCLL and UBA services, 21 July 2014.

¹³ Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014.

overall market (such as the global financial crisis). As Network Strategies note “the disadvantage of the short time period is that there is insufficient information to smooth out any seasonal or cyclical effects, if present. Furthermore data from the early days of Chorus’ trading may contain some anomalies due to initial sentiment associated with the implementation of separation.”¹⁴

- c. As noted above, it should be recognised TSLRIC is based on a hypothetical efficient operator, not Chorus. For example, the impact that the Commission’s pricing determinations, or the financial difficulties Chorus is purporting to have in relation to its UFB roll-out, on Chorus’ equity beta are not relevant to the determination of the equity beta for a hypothetical efficient operator.
11. We agree with PricewaterhouseCoopers that while Oxera conclude “Statistical testing suggests that the observable Chorus beta is robust for use in estimating the equity beta for UCLL and UBA”¹⁵ it is unclear how this could be the case, given the limited history as a listed company, the significant instability (downwards) in its share price (related to Commerce Commission pricing determinations) and the substantial difference between Chorus and a hypothetical efficient service provider.
 12. The dominance of Chorus in the calculation of the equity beta is illustrated vividly by the title of section 6 of the Oxera Report “Is there evidence for a different beta for UCLL and UBA, relative to Chorus?” If the comparative data set used was not dominated by Chorus, Oxera would be able to ask the more appropriate question “Is there evidence for a different beta for UCLL and UBA, relative to the comparative data set?”
 13. The dominance is further illustrated by Oxera’s conclusions in which it makes “recommendations for the cost of capital calculation for Chorus”.¹⁶ The TSLRIC determination process requires the determination of the equity beta/WACC for a hypothetical efficient service provider, not Chorus. We are alarmed Oxera seem to treat the two exercises as identical.
 14. We agree with Telecom’s conclusion that “By undue focus on Chorus’ own actual beta the risk is that the subsequent analysis of asset beta for a hypothetical UCLL and UBA operator is likely to be overly influenced by the perception of Chorus’s position without taking account of the issues related to structural separation, regulatory change, the influence of the fibre roll-out and agreements with Crown Fibre Holdings, (and additionally certain unregulated services other than UCLL and UBA which may also drive additional joint and common costs and risks) ... In other words, significant weight on Chorus’ own asset beta is likely to make it more difficult to carry out a proper comparison with a fixed access network operator providing solely ULL and UBA services. The hypothetical UCLL and UBA provider estimated beta should likely better be derived from comparator datasets including diversified telecommunications operators, and regional infrastructure businesses, and finally, tested for consistency with Chorus, possibly with a high-level cross-check against regulatory precedent”.¹⁷ This assessment should also not be based on Chorus’ total business or the equivalent hypothetical including UFB with its different risk profile to copper.

Oxera equity beta is substantially above that used for the TSO copper services’ cost determinations

¹⁴ Network Strategies, Expert reports on WACC for UCLL and UBA FPP, 21 July 2014, page 19.

¹⁵ Oxera, Review of the beta and gearing for UCLL and UBA services: Evidence and recommendations, June 2014, page 21.

¹⁶ Oxera, Review of the beta and gearing for UCLL and UBA services: Evidence and recommendations, June 2014, page 57.

¹⁷ Telecom, Expert reports on the cost of capital for UCLL and UBA price review”, 21 July 2014, paragraphs 26 and 27.

15. We also note that the Oxera report conclusion that the equity beta should be between 0.55 and 0.85 with 0.7 being the mid-point fits with the range of other recent Commerce Commission equity beta determinations,¹⁸ but is substantially higher than the equity beta used for the PSTN TSO net cost determinations.¹⁹ It is not apparent why the equity beta for UCLL and UBA copper services should be so much higher than the equity beta for TSO copper services. We agree with PricewaterhouseCoopers that “It would be useful to understand how the Commission and its advisor, Oxera, view the assessment of systematic risk for UCLL and UBA services versus that of TSO services”.²⁰

Dr Lally is right to reject CEG’s attempts to have the WACC determination inflated

16. The Lally Report dismisses all but one of CEG’s attempts (on behalf of Chorus) to persuade the Commission to set an inflated WACC for UCLL and UBA services, which would be higher permissible under the Part 4 WACC IMs. We support Dr Lally’s arguments for dismissing CEG’s proposals, and the related arguments by Telecom and Network Strategies in support of Dr Lally’s views.

Concern that Dr Lally’s views on Chorus average term of debt are inconsistent with the approach taken under Part 4 of the Commerce Act, which was endorsed by the High Court in the Merit Appeal decision

17. The one exception is that Dr Lally, while rejecting CEG’s criteria for selecting the appropriate debt policy as too narrow, suggested “recourse to a more comprehensive set of tests leads to the conclusion that the best policy is to invoke the risk free rate at the beginning of the regulatory cycle (with a term matching the regulatory cycle) coupled with a DRP at the beginning of the regulatory cycle (with a term matching the average term for which firms borrow)” (emphasis added).²¹ Network Strategies supported Lally’s position but we have a number of concerns.

18. First, it is inconsistent with the approach adopted in the Part 4 WACC IMs. The Commission’s WACC methodology was comprehensively challenged in the Part 4 IM Merit Appeal case, and endorsed by the High Court (December 2013 decision).

19. Second, the only reason we can see for adopting a different approach to this aspect of WACC is that the TSLRIC determination is based on a hypothetical efficient operator, whereas the Part 4 price determinations are not. This would suggest the option of applying actual term of debt would be more applicable under Part 4 of the Commerce Act than under Part 2 of the Telecommunications Act. The reality is that Chorus’ term of debt is driven by a number of factors which have little or nothing to do with their historic copper network e.g. roll-out of the UFB network and its generous dividend policy through the roll-out process.

20. Third, to ensure consistency across industries and between the Commerce Act and Telecommunications Act, we consider that the Commission should only consider this deviation from the Part 4 IMs if it does so in conjunction with review of whether the Part 4 WACC IMs should also be amended. This would be highly relevant to the Commission’s Transpower IPP and

¹⁸ 0.61 for electricity distribution and Transpower, 0.79 for gas distribution and transmission and 0.72 for Airport (Commerce Commission Part 4 Commerce Act Input Methodologies).

¹⁹ Pre-split Telecom PSTN TSO Business – 0.286 (2007/08, 2006/07, 2005/06, 2004/05) with a “high” estimate of 0.571.

²⁰ PricewaterhouseCoopers, Submission on the Commerce Commission Expert’s paper: Review of the beta and gearing for UCLL and UBA services, 21 July 2014, paragraph 33.

²¹ Dr Martin Lally, Review of submissions on the cost of debt and TAMRP for UCLL and UBA services, 13 June 2014, page 19.

electricity distribution DPP 2015 price reset processes which it is conducting this year.

Chorus' assertions that its copper business should be granted a higher WACC than for energy networks are unfounded

21. Chorus' asserts "Reasonable expectations suggest that the WACC determined by the Commission in telecommunications should be greater than it would calculate for regulated electricity and gas networks".²²
22. The logic behind this position, however, isn't particularly clear or coherent.
23. The position appears to be, in part, because Chorus does not consider that the WACC IMs produce an adequate WACC rather than because the telecommunications WACC should be higher than the energy WACC per se.
24. Chorus goes onto state that "asset betas for telecommunications fixed line network providers are set higher than for electricity and gas networks in Australia by the ACCC/AER and in the United Kingdom by Ofcom/Ofgem" and vaguely claims that "the same pattern" exists for "United States firms".²³ This is far from a comprehensive benchmarking of WACC determinations. Regardless, the claims fail to distinguish between telecommunications service providers and providers of UCLL and UBA services. It may well be that the appropriate asset beta/WACC for telecommunications service providers in general is higher than for energy, but it does not follow that the specific asset beta/WACC for a hypothetical efficient service provider of UCLL and UBA services would be.

²² Chorus, Submission in response to the Commission's expert reports on the cost of capital for the UCLL and UBA price reviews, 21 July 2013 [sic], paragraph 10.

²³ Chorus, Submission in response to the Commission's expert reports on the cost of capital for the UCLL and UBA price reviews, 21 July 2013 [sic], paragraph 10.

Part 4 Commerce Act and Part 2 Telecommunications Act WACC decisions are related and the Commission needs to have full regard of the implications of consultation/submissions in one jurisdiction for the other

25. The Commission has noted that “There is potential overlap between the issues and material being considered in the cost of capital IMs WACC percentile process, and the UCLL and UBA WACC processes”.²⁴ There is more than potential. We think the two processes are integrally tied up.
26. The Commission goes on to state that the WACC IM processes and UBA/UCLL processes “should operate separately” and “except where we expressly say otherwise, we will not have regard to submissions from: ... the cost of capital IMs process in the UCLL and UBA processes; and ... the UCLL and UBA processes in the cost of capital IMs process”.²⁵
27. We find this position surprising in light of the Part 4 Judicial Review challenge against the Commission in relation to whether the Commission could legitimately run consultation and determination processes which overlapped multiple sectors. The High Court found in the Commission’s favour. The comments from the Chair of the Commission, Dr Mark Berry, made at the time were quite critical of the Judicial Review challenge stating that it was “without real merit” and that “it is not clear to us what real benefit the parties were seeking from the process challenge”.²⁶ The Commission now appears to be adopting processes that align with the unsuccessful Judicial Review challenges.
28. We consider it to be self-evident various submissions, and respective consultation papers, on the Part 4 WACC IM/IPP/DPP processes are relevant to the UCLL and UBA TSLRIC price determination processes, and vice versa. When parties from one sector respond to consultation in another sector/jurisdiction it can be taken as a given they are doing so because of the cross-sector relevance/precedent. It is common for the submitters to be explicitly upfront about this. Transpower, for example, noted that “submissions made under Part 2 are likely to have relevance to Part 4 and vice versa”.²⁷
29. Matters of particular relevance include:
 - a. The concerns expressed by Vector about unexplained inconsistencies in approach between Part 2 of the Telecommunications Act and Part 4 of the Commerce Act in relation to asymmetric cost, and their view that the Commission has been more permissive towards erring on the high side for price determinations under the Telecommunications Act than the Part 4 of the Commerce Act.²⁸ These concerns are reinforced by the Commission’s “Consultation paper outlining our proposed view on regulatory framework and modeling approach for UBA and UCLL services”, 9 July 2014, which makes multiple references to the

²⁴ Commerce Commission, Further work on cost of capital input methodologies: Process update, 23 June 2014.

²⁵ Commerce Commission, Further work on cost of capital input methodologies: Process update, 23 June 2014, paragraph 13.

²⁶ Dr Mark Berry, Commerce Commission Chair, An Update from the Commerce Commission, Annual Competition Law and Regulatory Review conference, Wellington, 28 May 2012 at 9:40am.

²⁷ Transpower, Cross-submission: determining the cost of capital for the UCLL and UBA price reviews, 11 April 2014.

²⁸ Vector, Submission to the Commerce Commission on Scoping and Issues Discussion Paper for UCLL TSLRIC, 14 February 2014.

importance of respecting “reasonable investor expectations”, a term that we could not find any reference to in the current Part 4 WACC IM/IPP/DPP consultation processes.²⁹

- b. Chorus states that “The Lally and Oxera Reports ... make proposals that depart from the IMs for other industries. Where Dr Hird and Professor Grundy are also recommending departures from the IM position this advice should be considered on its merits.”³⁰ Any deviation from the WACC IMs that the Commission adopted, in relation to generic WACC determinants, would have major precedent value for Part 4. The Commission should not consider any such changes without also considering the views of interested parties as to whether the WACC IMs should also be amended. The Commission should only consider such deviations jointly, or in parallel consultation processes.

We note that the Commission is currently reviewing aspects of the WACC IMs as part of its Transpower IPP and EDB DPP price resets. We also note the High Court view that “it is hard to escape the sense that the Commission, in two of its individual parameters choices – debt issuance costs and asset beta, was – as MEUG asserted – included to err in favour of suppliers”.³¹

- c. There have been various submissions, in both the Part 4 WACC IM/IPP/DPP and the UCLL/UBA TSLRIC price determination processes, that provided evidence why the WACC percentile adopted for electricity should be higher than for copper, and that the arguments for adopting an above mid-point WACC percentile for electricity are stronger than they are for copper e.g. CallPlus, PricewaterhouseCoopers and Transpower. The submissions have cross-referenced submissions from the alternate jurisdiction process. The initial observations we provide below on the Commission’s Part 4 WACC percentile consultation paper, and related expert reports on WACC percentile,³² also illustrate how evidence the Commission is compiling for the Part 4 WACC IM process has relevance UCLL and UBA TSLRIC FPP price determination processes.
- d. In respect of the last point, we note a Castalia report for Transpower highlights differences between regulated suppliers/access providers in different sectors.³³ Castalia point out one difference is that some suppliers provide services where there is no realistic substitute, such as electricity distribution and transmission, whereas others such as Chorus’ copper network, face substitutability from alternative technology such as mobile services and fibre provided by LFCs. Castalia suggest that where substitutes exist there is less scope for the regulated supplier to defer investment in response to a low WACC percentile, than there is for other regulated suppliers, as they would face the risk of loss of customers and revenue (analogous to a workably competitive market outcome). This submission would seem to be highly relevant to determination of WACC percentile under both Part 4 of the Commerce Act and Part 2 of the Telecommunications Act.
- e. The Commission’s release of a Part 4 WACC percentile consultation paper stating that it intends to move from a 75th percentile WACC for energy networks, and instead adopt a 67th

²⁹ The term was used by the High Court in the Part 4 IM Merit Appeal decision. Refer: Wellington International Airports Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013], paragraph [605].

³⁰ Chorus, Submission in response to the Commission’s expert reports on the cost of capital for the UCLL and UBA price reviews, 21 July 2013 [sic], paragraph 8.2.

³¹ Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013], paragraph 1457.

³² Refer: Some initial observations about the relevance of the Part 4 WACC percentile expert reports for the UBA and UCLL TSLRIC price determinations

³³Castalia, report to Transpower, The Rational Response of a Regulated Transmission Company to a Low WACC, 1 May 2014, footnote 6.

percentile WACC, with the prospect that the Commission will adopt a lower percentile for airports, and is open to consideration of a differential WACC between electricity and gas, has profound implications for the setting of WACC for UCLL and UBA services.

The Commission's Part 4 WACC percentile consultation paper effectively 'lowers the bar' for the UCLL and UBA WACC determination. It follows that if the appropriate WACC for energy utilities is 75th percentile then the WACC percentile for UCLL and UBA should be substantially below 75th. It follows also that if the appropriate WACC for energy is 67th percentile, then the WACC percentile for UCLL and UBA should be substantially below 67th.³⁴

³⁴ This point is discussed in more detail in the following section.

Part 4 WACC percentile consultation material suggests a lower WACC for the UBA and UCLL TSLRIC price determinations

30. As should be clear from the discussion above, and numerous of the WACC submissions made under both Part 2 of the Telecommunications Act and Part 4 of the Commerce Act, the determination of WACC percentile for UBA and UCLL services, and for services currently regulated under Part 4 of the Commerce Act, are highly interrelated with compelling arguments that the WACC percentile adopted for UBA and UCLL services under Part 2 of the Telecommunication Act should be substantially lower than the WACC percentile selected for electricity under Part 4 of the Commerce Act.³⁵
31. It may well be the case that electricity transmission, electricity distribution, gas transmission, gas distribution, airports (potentially distinguishing between domestic and international), copper and other telecommunications services all warrant different WACC percentiles. This needs to be fully explored and tested. So far the Commission has only conceded that it will consider a distinction between energy and airports, though it has provided reasons why electricity versus gas, and transmission versus distribution may, in principle, differ.
32. As noted above, the Commission's Part 4 WACC percentile consultation paper effectively 'lowers the bar' for the UCLL and UBA WACC determinations, such that the WACC percentile selected for UCLL and UBA should be no higher than 67th percentile. The 67th percentile should only be selected if the Commission has evidence that it should reject arguments in favour of differential WACC percentiles for different industries and jurisdictions e.g. telecommunications (copper) versus airports versus energy (or even versus electricity and gas, and distribution versus transmission).
33. Based on the Commission's intention to apply a WACC range for information disclosure between 33 and 67th percentile the appropriate WACC for Chorus could be as low as 33th percentile. Alternatively, we note the Part 4 WACC percentile consultation paper's reference to the seminal work undertaken by Dobbs which indicates the WACC percentile for sunk investments should be set at the 45th percentile.³⁶ Notably, Dr Lally concluded that "[t]he best available analysis on this matter is provided by Dobbs".³⁷
34. Specific observations we have in relation to the Part 4 WACC percentile consultation paper include:
- a. **Incentives to invest are largely irrelevant for copper services:** The principal argument in favour of a WACC percentile above mid-point is concern over incentives to invest, and asymmetry of risk from prices that are too low versus prices that are too high. For example:

In our view, it is appropriate to use a WACC significantly above the mid-point estimate for price-quality path regulation. This is because the potential costs of under-investment from a WACC that is too low are likely to outweigh the harm to customers (including over-investment) arising from a WACC that is too high.³⁸

³⁵ The only submission that contradicted this was that of Vector which argued that the WACC percentile should be the same for copper and energy.

³⁶ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph 5.10.1.

³⁷ Dr Martin Lally, The appropriate percentile for the WACC estimate, 19 June 2014, page 2.

³⁸ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph X17.

These types of arguments are not applicable to UCLL and UBA given the limited future investment in copper (as opposed to fibre and other technologies), and therefore should not be relied on to justify a WACC for UCLL and UBA above mid-point.

Consistent with this, the Part 4 WACC percentile consultation paper also makes reference to the NZIER analysis that the welfare maximizing WACC percentile is highly sensitive to the ratio of sunk assets to new investments.³⁹

- b. **Current 75th percentile under Part 4 has no precedent value:** The statement that “The consequence of the Court’s judgment is that the Commission’s previous choice of the 75th percentile does not logically have any special standing as the status quo”⁴⁰ also means it cannot serve as precedent for choice of WACC percentile in other jurisdictions such as under Part 2 of the Telecommunications Act. The relevant precedents are mid-point for TSO net cost determinations and the draft PSTN TSLRIC determination.
- c. **Deadweight loss impacts:** The Part 4 WACC percentile consultation paper makes reference to small deadweight loss impacts from a high WACC percentile that ASEC (on behalf of Unison) produced as grounds for erring on the side of a high WACC percentile.⁴¹ The Commission rightly noted that “having regard to consumer welfare, rather than focusing on deadweight loss, may impact on ASEC’s conclusions”.⁴² We agree. We also note that the elasticity of demand for copper services is substantially more elastic than for electricity services, so the deadweight loss impact of a high WACC percentile will be substantially greater than for electricity. This reinforces our view that the appropriate WACC percentile for UCLL and UBA services will be lower than for energy under Part 4 of the Commerce Act.
- d. **Differential treatment of different sectors:** we agree with the Commission’s observation that “As noted by Oxera, one of the themes raised in the expert submissions we have received is that the risks and incentives to invest differ on a sector-by-sector basis. Oxera noted that it may be helpful to supplement the energy market analysis that has been conducted with examples from other industries, when considering whether the WACC percentile for energy businesses should be applied across other sectors”.⁴³

This is consistent with the previous advice of Professor Franks that WACC percentile should be evaluated on a case-by-case basis.⁴⁴ The Commission accepted this advice agreeing that “[t]he extent to which the Commission departs from the mid-point is a matter of judgment and must be assessed on a case-by-case basis”.⁴⁵ The Commission has stated that it will give consideration to whether the WACC percentile for airports should be lower than 67th percentile.

³⁹ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph 5.5.1.

⁴⁰ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph 2.6.

⁴¹ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph 5.39.1.

⁴² Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, footnote 160.

⁴³ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph 6.45.

⁴⁴ Franks, Lally and Myers, Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology, 18 December 2008, paragraph 21.

⁴⁵ Commerce Commission, Revised Draft Guidelines: The Commerce Commission’s Approach to Estimating the Cost of Capital, 13 June 2009, paragraph 240.

We are concerned that this matter hasn't been given sufficient consideration; it should not just be limited to energy versus airports.

The Commission is so far silent on the matter in relation to copper versus energy services.

The Commission noted that legislative differences could have implications for whether EDBs and Transpower should have different WACC percentiles but makes the assumption, without evidence to support, that "the differences between EDBs and Transpower do not justify a different WACC percentile".⁴⁶ This is surprising given the different investment profiles over the last several years, and the different mix of sunk and new.

Similarly, while the Commission "accept that there are differences between electricity lines and gas pipelines" it just assumes "these industries [are] similar enough for the same WACC percentile to apply".⁴⁷ While we do not profess to be an expert on these sectors, it would surprise us if this conclusion was correct. We would assume that the future investment profiles of the two sectors would be quite different, and that investment in gas infrastructure, which is a discretionary services for most end-users, would be much less important for consumer and economic welfare than investment in electricity infrastructure.

The lack of supporting evidence is particularly disappointing given the driver for the High Court view that the Commission should revisit the choice of WACC percentile was that the evidence in support of the existing percentile was inadequate. We would not like to see the same mistakes being repeated. We believe the next step in the Commission's Part 4 WACC percentile review should be to review whether 67th percentile is appropriate for all sectors, or whether it should select different WACC percentiles for any or all of airports, copper, electricity, gas and potentially other telecommunications services.

The WACC expert reports' justifications for above mid-point WACC are not relevant for copper

35. We have the following initial observations about the Part 4 WACC percentile expert reports to the UCLL and UBA TSLRIC price determinations:
- a. Dr Lally reinforces the submissions made by CallPlus et al that "the appropriate WACC margin will vary across industries, depending upon factors such as the price elasticity, the risk of excessive investment arising from supernormal WACC allowances, the speed with which a regulatory would eventually react to an underestimate of WACC, and the presence or absence of 'dual-till' operations".⁴⁸
 - b. Dr Lally rejects using different margins for different industries on the basis that "difficulties in estimating these differential rates preclude this course of action. The one exception that I would make would be to not use a margin in circumstances in which the appropriate margin is considered to be much lower than normal. A possible example of this would be 'dual-till' operations in which the flow-on benefits from regulated operations to unregulated operations with the same owner would be substantial".⁴⁹

⁴⁶ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph 6.47.

⁴⁷ Commerce Commission, Proposed amendments to the WACC percentile for electricity lines services and gas pipeline services, 22 July 2014, paragraph 6.48.

⁴⁸ Dr Martin Lally, The appropriate percentile for the WACC estimate, 19 June 2014, page 2.

⁴⁹ Dr Martin Lally, The appropriate percentile for the WACC estimate, 19 June 2014, page 24.

We note that the dual-till argument is applicable where the “the presence of benefits received by the owner of a regulated business that flow from but are not part of the regulated business”. This could include both Chorus’ unregulated businesses and separate regulated businesses (that aren’t part of the UCLL and UBA businesses); and particularly Chorus’ proposed “boost” service (which is just the regulated service dressed up with lipstick).

- c. Dr Lally’s comment on Dobbs assumption that all existing investment is sunk is worth noting. Dr Lally argues that to the extent this assumption does not hold all existing investments eventually become new investments implying the appropriate WACC estimate would have to increase.⁵⁰ Given the transition from copper to fibre, which is largely being undertaken by Chorus, and the Commission’s view that a hypothetical efficient operator would not rebuild a copper network, we consider it appropriate to treat the copper network as sunk as per Dobbs. This means Dobbs’ calculation of 45th percentile for sunk assets is highly germane for UCLL and UBA services. There is no alternative evidence based percentile that the Commission could select without the Commission undertaking substantial work (paralleling that for the Part 4 WACC percentile).
- d. Oxera conclude, “given the specific circumstances of electricity transmission and distribution” (emphasis added), that 50th would likely be too low, and 80th to 90th would be too high, but “a point estimate around the 60th and 70th percentile appears to provide a suitable balance between the costs and benefits of the appropriate of setting a higher percentile in mitigating the risks associated with the underinvestment problem”.⁵¹ This is notable because: (i) the range that Oxera consider to be most appropriate is below the current 75th percentile used in the Part 4 WACC IMs; and (ii) Oxera’s analysis is heavily weighted by consideration of incentives to invest.

Oxera also state that “Our framework illustrates” that the optimal WACC percentile “is only likely to be the 50th percentile either where the consequences of underinvestment are low, or where the link to the WACC is low” (emphasis added).⁵²

As CallPlus has discussed in previous submissions, while incentives to invest are highly relevant to electricity network services under Part 4 of the Commerce Act, they are not particularly relevant to Chorus’ copper network. As we noted previously, “concerns about incentives to invest in copper would be akin to concerns about whether electronic good manufacturers would continue to invest in manufacture of VHS video recorders, tape decks and tube TVs”.⁵³

- e. It is noted that Ingo Vogelsang does not appear supportive of an above 50th percentile WACC.⁵⁴ He argues that “only under certain conditions will a move from the midpoint WACC to such a higher WACC be justified. These conditions include (a) very large effects of the change in WACC on the amount of investment, (b) very strong welfare effects of the changed investments, and (c) the possibility that even at the elevated WACC investment remains sub-optimal.”⁵⁵ Again, the arguments for an above mid-point WACC are contingent

⁵⁰ Dr Martin Lally, The appropriate percentile for the WACC estimate, 19 June 2014, page 13.

⁵¹ Oxera, Review of the ‘75th percentile’ approach, 23 June 2014, page 6.

⁵² Oxera, Review of the ‘75th percentile’ approach, 23 June 2014, page 3.

⁵³ CallPlus, Submission to the Commerce Commission on technical consultation paper “Determining the cost of capital for UCLL and UBA price reviews, 28 March 2014, paragraph 52.

⁵⁴ Ingo Vogelsang, On the economic effects of allowing a WACC above midpoint, 12 June 2014.

⁵⁵ Ingo Vogelsang, On the economic effects of allowing a WACC above midpoint, 12 June 2014, page 1.

on the importance of incentives to invest (not applicable to copper).

- f. Ingo Vogelsang reinforces our point that different WACC percentiles may be justified for different industries: “Without having done detailed research for all the industries in question I conjecture that the investment issue differs substantially for different types of investment within industries, such as electricity distribution and airports, and for different types of investments within industries, such as investments for reliability or for adding new customers or for smart grid innovations ...”⁵⁶
- g. Professor Julian Franks⁵⁷ supports above 50th WACC on the basis of the importance of investment, and that the costs of under-investment are greater than the costs of over-investment. Professor Franks argues that “The size and cost of the under-investment problem will be affected by a number of factors” which include “The level of investment. With higher future levels of investment, the greater the under-investment problem, and with lower levels of investment, the smaller the under-investment problem”.⁵⁸ These comments should be considered in the context of the transition from copper to fibre, and that incentives to invest in copper are not an important consideration.
- a. Economic Insights suggests the New Zealand 75th percentile “is generally higher than the estimates from other jurisdictions” and “The international review of regulatory cost of capital decisions indicates there has been a tendency in more recent decisions in several jurisdictions to reduce basis point adjustments or adopt a midpoint estimate”.⁵⁹

⁵⁶ Ingo Vogelsang, On the economic effects of allowing a WACC above midpoint, 12 June 2014, page 2.

⁵⁷ Professor Julian Franks, Memorandum, 20 June 2014.

⁵⁸ Professor Julian Franks, Memorandum, 20 June 2014.

⁵⁹ Economic Insights, Regulatory Precedents for Setting the WACC within a Range, 16 June 2014, page iv.