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Regulation Branch  
Commerce Commission  
Wellington

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## **Vector submission on cost of capital for UCLL and UBA reviews**

1. Vector welcomes the opportunity to provide this submission on the Commerce Commission's (Commission) consultation paper *Determining the cost of capital for the UCLL and UBA price reviews* (consultation paper), dated 7 March 2014.

### **Consistency between WACC IMs and the telecommunications WACC**

2. Vector agrees that the Commission should use the cost of capital input methodologies (WACC IMs) as the starting point for estimating WACC for the UCLL and UBA services.
3. We also agree that there is no clear reason to use different approaches to determining the returns investors require for the different sectors (although certain parameter values will of course vary).
4. The rate of technology change in telecommunications may be faster than for electricity and gas (although, for electricity at least, this variance is shrinking as electricity lines businesses increasingly adopt smart network technologies). However, in our view, this sort of issue may affect sector-specific parameters such as beta, but does not provide justification for taking an overall approach to setting WACC that is materially different from that determined under the IMs.

5. We also agree that there are interdependencies between the WACC and other elements of the TSLRIC modelling for the UCLL and UBA services and the Commission should consider these interdependencies when it determines the WACC.

### **Setting the WACC at, above or below the mid-point estimate**

6. The Commission is seeking views on whether it should set the telecommunications WACC at, above or below the mid-point of the WACC range. Vector considers that the decision the Commission makes on the WACC percentile for telecommunications should be consistent with the decision it makes on the WACC percentile under the IMs, unless new evidence supporting a particular approach emerges between decisions.<sup>1</sup> We are not aware of any reason for telecommunications services to require a WACC percentile to be set differently from the WACC percentile in the IMs.
7. Vector's position is that a WACC set at the 75<sup>th</sup> percentile (or another adjustment with a similar effect) is a materially better way of determining the cost of capital in the long-term interest of consumers. We refer the Commission to our recent submission on this topic in relation to the WACC IMs<sup>2</sup> and to any subsequent evidence and information we provide during any forthcoming WACC IM review. To the extent the economic principles to be applied are common, this information will also be relevant to the determination of WACC for telecommunications services.
8. In this respect, it would be helpful if the Commission could identify (at an early stage):
  - a. which aspects of the telecommunications WACC consultation it considers relevant to any future Part 4 WACC IM review; and
  - b. whether it considers the purpose statement in the Telecommunications Act or the characteristics of the telecommunications sector require the application of different economic approaches from those applied under Part 4.
9. This information would help ensure the issues are appropriately consulted on during the process.

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<sup>1</sup> We do not believe these decisions need to be made at the same time. It is open for the Commission to determine WACC for telecommunications services in 2014 and review the WACC IMs by 2017.

<sup>2</sup> Vector Limited, *Submission to Commerce Commission on whether the Commission should review or amend the cost of capital input methodologies*, 13 March 2014.

10. In its discussion of whether to set the WACC at a level that varies from the mid-point, the Commission raised three further issues, which may be more relevant to the telecommunications sector:<sup>3</sup>
  - a. That “the efficiencies that will result, or will be likely to result, from deviating from the mid-point will need to be considered”;
  - b. That “investment incentives faced by both the access provider and access seekers are relevant”; and
  - c. That “demand uncertainty is more appropriately addressed when estimating cash flows, rather than the WACC, except to the extent that the demand uncertainty is correlated with the overall market. Uncertainty that is correlated with the overall market will be reflected in the beta by definition.”
11. We comment on each of these in turn below.
12. In relation to point a, the asymmetry effects of under investing relative to over investing are well understood, at least in concept. If a regulated WACC is set too high (and all other parts of the price control are precisely correct), consumers lose out from higher prices but gain from some inefficiently high-quality and inefficiently early innovation and investment. Conversely, if the determined WACC is too low, consumers gain from lower prices but miss out from the foregoing and retarding of innovation and investment. In economic efficiency terms, a higher WACC may risk some deadweight loss but a WACC set too low may risk all of the area under the demand curve. Hence, a requirement for the Commission to consider the efficiencies that will result, or will be likely to result, from deviating from the mid-point would seem unlikely in concept to result in a different conclusion from that reached by the Commission in determining the IMs; a WACC set at the 75th percentile WACC adjustment is a part of a materially better approach to setting the cost of capital in the long-term interest of consumers.
13. In relation to point b, an empirical estimate of the asymmetry effects of under investing relative to over investing should ideally account for the incentive effects on both access providers and access seekers. However, given that the losses to consumers from under investment are likely to be an order of magnitude greater than the losses from over investment (in economic terms, the area under the demand curve relative to Harberger’s triangle), whether the investment is made by the access provider or the access seeker would seem unlikely to alter the result. This intuition may explain why in 10 years of Commerce Commission decisions and

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<sup>3</sup> Consultation paper, pages 21-22.

regulatory practice under which the 75th percentile WACC has been applied in numerous decisions, no submitter to Vector's knowledge has provided empirical evidence of investment in the electricity sector displaced as a result of the Commission's WACC determination.

Also, from a telecommunications perspective it is not clear that the investment incentives of copper access seekers are very relevant, given that access seekers' investment horizons for copper access services are very short. We understand that access seekers tend to require a return over three years in order to justify an investment in equipment for UCLL and the number of areas where that is likely to be possible is diminishing rapidly with the UFB rollout and the approach of unbundled fibre in 2020.

14. In relation to point c, Vector agrees that, in principle, uncertainty in demand should be addressed in the cash flow projections rather than WACC. This is one of the reasons for why the approach to setting WACC should not be determined in isolation of the other elements of IMs or the UCLL and UBA price reviews.

### **Consultation process and timeframes**

15. The Commission has provided a three-week period for this consultation. The Commission invites submissions that are "supported by evidence"<sup>4</sup> on:
  - a. the approach to estimating and specific values for, asset beta, leverage and the implied long-term credit rating for the UCLL and UBA;
  - b. whether WACC should be set above or below the mid-point; and
  - c. whether a term credit spread differential allowance should be applied.
16. Vector submits that it is simply not possible to provide evidence on all of these issues within three-weeks. We recognise the Commission is bound by statutory deadlines for its UCLL and UBA price reviews, but a robust consultation process is still required. Ahead of the draft determination, a robust process would need to allow for responses to any initial expert evidence and a conference or workshop (so that any differences between the experts could be identified, explored and, if possible, resolved). Otherwise the Commission risks making a determination based on limited or untested information. Such steps have not been provided for in the Commission's proposed timeline as set out on page 24 of the consultation paper.

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<sup>4</sup> Consultation paper, page 6.

17. Finally, we may wish to provide expert evidence in this process. However this will depend on the Commission's clarification of potential overlap between this process and any future Part 4 WACC IM review.

### **Contact details**

18. If you would like to discuss this submission or have any further questions please contact me at 09 978 8340 or at [allan.carvell@vector.co.nz](mailto:allan.carvell@vector.co.nz).

Kind regards,



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