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Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies

On 20 February the Commerce Commission (Commission) released a paper seeking views from interested parties as to whether it should consider reviewing or amending the input methodologies for the cost of capital that apply to electricity lines services, gas pipeline services and specified airport services regulated under Part 4 of the Commerce Act.

This action was taken in response to the December 2013 High Court judgement on the merits appeals of the input methodologies set by the Commission in December 2010. Notwithstanding the High Court dismissing all the appeals against the cost of capital IMs, it did question whether the Commission's approach of using the 75th percentile estimate of the WACC to set price-quality paths was appropriate and may indeed be at odds with the objective of limiting the ability of regulated suppliers to earn excessive profits.

The Commission has expressed some concern that the current uncertainty regarding the position it may adopt in the future on this issue undermines the investment incentive intended to be promoted through use of the 75th percentile when setting price-quality paths.

The Commission has also highlighted the concerns raised by the High Court in respect of:

- Whether to adopt a "split" cost of capital to differentiate between existing assets and future investment;
- The rationale for a term credit spread differential allowance; and
- Whether the leverage anomaly arising from use of the simplified Brennan Lally CAPM warrants consideration of an alternative model.

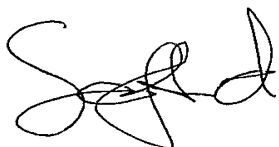
The Commission is therefore seeking views on whether it should undertake a review at this time and, if so, whether this review should be in respect of the 75th percentile estimate of WACC only or whether it should also cover the other issues highlighted by the High Court. The Commission considers that a review focussing on the 75th percentile issue could be completed before November 2014, whereas a more comprehensive review would take significantly longer. The relevance of the November 2014 timeline is due to the scheduled reset of EDB DPPs and Transpower's IPP to take effect from April 2015. Failure to reach a conclusion on this issue prior to this reset would result in ongoing uncertainty and the potential that consumers end up paying significantly more than appropriate for EDB and Transpower's services, contrary to the objective of Part 4 of the Commerce Act.

Air New Zealand agrees with the Commission that the High Court's ruling has created uncertainty regarding the appropriate point on the WACC range to use when setting price-quality paths. Air New Zealand notes the impact of this uncertainty extends wider than simply price-quality paths established by the Commission given that Wellington Airport, in its current pricing consultation, is proposing setting prices for the next five years based on the 75th percentile WACC as this "is consistent with the Commission's approach to setting the WACC IM as a reasonable method for dealing with estimation uncertainty". Similarly in its recent section 56G reviews of price-setting disclosures by the three airports subject to Part 4 regulation, the Commission's focus on the 75th percentile return resulted in quite different outcomes than if the mid-point WACC had been used, notwithstanding that all airports were found to be targeting "above normal" returns. The Commission adopted this approach notwithstanding the mid-point being described as the appropriate starting point for analysis. As a result Air New Zealand considers that the Commission should immediately seek to clarify its approach to this aspect of the cost of capital IMs for both pre-quality paths and for information disclosure.

The High Court emphasised in its judgement that the purpose of Part 4 is to protect the long-term interests of consumers and it was difficult to see how allowing suppliers to earn above-normal returns over the long-term could be seen as appropriately reflecting the objective of ensuring consumers interests were being maintained. As noted by the High Court, providing for above-normal returns on a permanent basis is unlikely to lead to innovation and efficient investment – "... necessity, not plenty, is the mother of invention." [para 1474, p.488] Furthermore, allowing higher than necessary input prices for user industries does nothing more than promulgate inefficiency throughout the economy. In the aviation sector, for example, an inflated cost base impacts on an airline's ability to price at levels which stimulate passenger growth and in turn generate revenues for the airline sufficient to enable it to invest in new, more efficient aircraft types as well as other innovations generating productivity improvements and stimulating market growth. Maintaining input costs at the appropriate level creates a virtuous cycle which generates benefits for all parties in the supply chain through better use of assets and increased throughput, generating better returns for all parties and enabling further investment.

Air New Zealand looks forward to participating in the Commission's review of the WACC IM.

Yours sincerely



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