Further work on the cost of capital input methodologies content:

Commerce Commission submission from AECT

Introductory remarks

The Auckland Energy Consumer Trust (AECT) welcomes the opportunity to provide a submission on the paper "Further work on the cost of capital input methodologies" issued by the Commerce Commission and dated 31 March 2014.

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The Commerce Commission wishes to address the regulatory uncertainty it believes has been created by the High Court judgment with an early and quick review of the use of the 75th percentile of the estimated WACC when setting price paths for regulated industries. We argued in our previous submission the need for a review that the Commission could address any uncertainty it felt was created by the High Court decision by including a review of the 75th as part of a general review of the IMs due within 7 years of their introduction. Similar arguments were made by other submitters.

Achieving 'certainty'

We agree that the questions raised in the High Court judgment about the quality of theoretical and empirical evidence supporting the use of the 75th percentile are valid and indicate that the methodology may need to be changed. However we argue that the Commission needs to consider such changes in a way that does not compromise the objective of certainty in s52R of Part 4.

We acknowledge that 'certainty' is a difficult concept to define. We suggest that it implies qualities of 'predictability' in decisions made by the Commission in the sense that:

- they can be anticipated by the stakeholders given the Commission's objectives, available evidence and current thinking by regulators
- once made are unlikely to be easily or quickly altered and if times are set for review either in legislation or as part of the decision these times are followed
- if decisions are altered, the alteration is based on a material change in market conditions or regulator thinking that is based on new evidence.

Accordingly we suggest that to ensure a change in the WACC percentile does not undermine the Part 4 objective of certainty that it should be considered against the following tests:

- there is reliable, clear and broadly accepted evidence of the
  - rationale for the change based on evidence of the distribution of the WACC, particularly its specific shape
  - likely effects of the change, in this case the effect on investment and service delivered and that any implied change in price will be passed through to consumers

- the potential for change including the rationale for a likely change should be signalled in advance to the owners and operators of regulated assets and implemented in a way to allow appropriate adjustment of investment plans
- the change has a low likelihood of reversal or successful challenge because it reflects either current accepted practice or the likely direction of travel in accepted practice by regulators

We consider a change in the use of the 75th percentile of the WACC against each of these criteria and suggest that a change in the use of the 75th percentile does not meet each of these tests.

Evidence of effects of the change

The evidence for the choice of one part of the WACC distribution over another is weak and inconclusive. The High Court judgment assessed that the evidence presented to the Court on the decision to choose the mid-point for the WACC over the 75th percentile was not adequate to demonstrate that using the mid-point WACC would provide consumers with a materially better outcome than the use of the midpoint. Our brief review of the literature suggests that the information presented to the Court was representative of the available evidence on this issue.

In practice the WACC is difficult to observe and calculate for unregulated industries with shares and bonds traded in liquid markets. For businesses such as lines companies where prices are regulated and trading of lines company shares is thin or non-existent, estimates of WACC rely more heavily on practitioner judgement and inference from other industries or overseas markets. In addition the application of WACC to business decisions about the capital structure (equity versus debt and the term structure of debt) and also the evaluation of new projects varies with business type and size.[1]

Therefore to avoid eroding stakeholder perception of the 'certainty' of the IM/ price-path if the Commission chose a WACC percentile other than the status quo it would need to be able to both:

- identify new and more reliable evidence of the effect of a different WACC that was not available to the Court.
- provide an assessment of the difference in quality between the evidence presented to the Court and the new evidence relied on by the Commission that would convince stakeholders that the Court would have probably have allowed the appeal if the new evidence had been presented.

Signalling the change

The plan by the Commission to complete the review by November will make it difficult for the Commission to meet this test if it decides to select a WACC percentile other than the status quo. If the Commission chooses another percentile it may wish to consider a phased adjustment to the new WACC as part of the setting of the price paths.

Low likelihood of reversal

As discussed under the heading "Evidence of effects of the change" we are sceptical that the Commission will be able to identify new empirical evidence to support the choice of a lower WACC percentile that is materially better than the empirical evidence that was presented to the High Court. An alternative approach would be for the Commission to base the selection of a different WACC percentile on changes in the decisions by regulators in similar markets overseas. Again our quick review of recent literature on regulator decisions suggests a mixture of judgments of about the appropriate point on the WACC distribution. The apparent lack of a trend in overseas regulator attitudes or a common framework for selecting a given percentile suggests it will be difficult for the Commission to meet this test if it decides to move away from the status quo.

[1] "The theory and practice of corporate finance: evidence from the field", John R. Graham and Campbell R. Harvey, Journal of Financial Economics 60 (2001) 187-243.