

## **Further work on cost of capital input methodologies: Process update**

Date: 23 June 2014

### **Purpose of this paper**

1. This paper provides an update on our process for further work on the cost of capital input methodologies (IMs). Specifically, this paper explains:
  - 1.1 the intended timing and scope of our draft decision regarding the appropriate weighted average cost of capital (WACC) percentile to be applied under the cost of capital IMs;
  - 1.2 why we have published our independent experts' reports now, and when we expect interested parties (and their expert advisors) to respond to these reports; and
  - 1.3 how we intend to manage the interaction between this process, and the work we are currently undertaking on WACC for two telecommunications services.

### **Background to further work on cost of capital IMs**

2. On 31 March 2014 we released a 'notice of intention' to do further work on the cost of capital IMs.<sup>1</sup> The aim of this further work is to address the High Court's comments regarding our use of the 75th percentile WACC estimate when setting regulated price-quality paths.<sup>2</sup>
3. When releasing the notice of intention, we noted that:<sup>3</sup>
  - 3.1 following the High Court's IMs judgment, there is uncertainty regarding the appropriate WACC percentile to be applied under the cost of capital IMs;
  - 3.2 our strong preference is to complete the further work on the WACC percentile before the end of November 2014, so that this uncertainty is addressed before the next regulatory period for electricity distribution businesses and Transpower; and
  - 3.3 after gathering further evidence (and conducting additional analysis) the WACC percentile could increase, decrease, or remain at the 75th percentile.

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<sup>1</sup> Commerce Commission "Notice of intention: Potential Amendments to Input Methodologies for Electricity Distribution Services, Gas Pipeline Services, Airports, and Transpower" (31 March 2014).

<sup>2</sup> Commerce Commission "Further work on the cost of capital input methodologies: Process update and invitation to provide evidence on the WACC percentile" (31 March 2014), page 2, paragraph 4.

<sup>3</sup> Commerce Commission "Further work on the cost of capital input methodologies: Process update and invitation to provide evidence on the WACC percentile" (31 March 2014), paragraphs 7, 10 and 18.

### **Intended timing and scope of our draft decision on the WACC percentile**

4. We currently intend to release our draft decision regarding the appropriate WACC percentile on **Tuesday 22 July 2014**.
5. Our draft decision will provide our view on the WACC percentile for energy businesses (electricity distribution businesses, Transpower and gas pipeline businesses). For the reason in paragraph 3.2 above, our analysis to date (and the independent expert advice we have received) has necessarily focussed on these businesses.
6. Submissions have raised several airport-specific considerations which may affect the appropriate WACC percentile for specified airport services – for example, the role of ‘dual-till’ regulation. While we expect that aspects of our draft decision for energy businesses will be relevant to airports, we have not had time to fully consider the airport-specific aspects of submissions at this stage.
7. Therefore, we intend to take additional time to consider the WACC percentile for specified airport services. We will release a process update paper on the WACC percentile for airports at a later date.

### **Independent expert reports we have published today**

8. We have received several independent expert reports to assist us in reaching our draft decision on the appropriate WACC percentile. These reports were prepared by:<sup>4</sup>
  - 8.1 European economic consulting firm Oxera;
  - 8.2 Professor Ingo Vogelsang of Boston University;
  - 8.3 Professor Julian Franks of London Business School;
  - 8.4 Associate Professor Martin Lally of Victoria University; and
  - 8.5 Australian economic consultancy firm Economic Insights.
9. We have also prepared a working paper about regulatory incentives and the cost of capital.
10. These expert reports, and our working paper, are now available on our website.<sup>5</sup> We have released this material in advance of our draft decision so that interested parties, and their experts, have additional time to consider the analysis and evidence we have collected. For the avoidance of doubt, these expert reports do not represent the Commission’s view on the appropriate WACC percentile.

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<sup>4</sup> We expect to receive an additional report from Professor Ingo Vogelsang, which peer-reviews Oxera’s report. We will release this additional report once it is available.

<sup>5</sup> See <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/further-work-on-wacc/>.

11. Although we have released these expert reports now, we are not inviting submissions at this stage. Interested parties will have an opportunity to submit on the material we have released today when responding to our draft decision.<sup>6</sup> The due date for submissions will be provided in our draft decision.

### **Interaction between work on the cost of capital IMs and telecommunications WACC**

12. We are currently undertaking separate work on the WACC for two regulated telecommunications services: the unbundled copper local loop (UCLL) and unbundled bitstream access (UBA) services.<sup>7</sup> There is potential for overlap between the issues and material being considered in the cost of capital IMs WACC percentile process, and the UCLL and UBA WACC processes.
13. As the cost of capital IMs process is being conducted on different timelines and under different legislation to the UBA and UCLL processes, our view is that it should operate separately. This means that, except where we expressly say otherwise, we will not have regard to submissions from:
- 13.1 the cost of capital IMs process in the UCLL and UBA processes; and
  - 13.2 the UCLL and UBA processes in the cost of capital IMs process.
14. Where we incorporate submissions from one process into another, we will ensure that parties interested in the second process have an opportunity to give their views on those submissions.<sup>8</sup>
15. Our approach to the interaction between the cost of capital IMs process and the UCLL and UBA processes may result in parties making similar submissions in multiple processes. However, we believe it is preferable that parties in all processes are clear about exactly what submissions we are considering when making our decisions.

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<sup>6</sup> Any additional submissions received in advance of our draft decision, including the June 2014 CEG submission for Unison, will not be considered until after we have released our draft decision.

<sup>7</sup> See <http://www.comcom.govt.nz/regulated-industries/telecommunications/regulated-services/standard-terms-determinations/unbundled-copper-local-loop-and-unbundled-bitstream-access-services-final-pricing-principle/> for further information on the UCLL and UBA pricing reviews.

<sup>8</sup> For example, our 7 March 2014 technical consultation paper on the WACC for UCLL and UBA expressly incorporated documents from the cost of capital IMs process into the UCLL and UBA process. Commerce Commission “Determining the cost of capital for the UCLL and UBA price reviews: Technical consultation paper” (7 March 2014), page 6, paragraph 13.