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Andy Burgess
General Manager
Commerce Commission
Wellington 6011
By email: im.review@comcom.govt.nz

Dear Andy

2023 Cost of Capital consultation

1. We are writing in regard to the Commerce Commission's (Commission) cost of capital consultation which is part of the Commission's input methodologies (IM) review. Although the consultation closed 3 February 2023 and the Commission has not invited cross-submissions we make the following observations on submissions made by submitters to the consultation.

<u>Weighted average cost of capital (WACC) percentile</u>

2. No new evidence was provided by submitters to support a move downwards from the 67th percentile.

3. In fact, three separate, independent experts presented the case to maintain or move upwards from the 67th percentile:

    a. Oxera[1] found that evidence supports targeting a WACC estimate in range of the 65th to 75th percentile. This suggests the 70th percentile is the most appropriate percentile to target;

    b. CEG[2] recommended that the Commission should give serious consideration to raising the percentile to the 75th to reflect the increased cost/risk of under investment as New Zealand decarbonises; and

    c. Frontier[3] illustrated that CEPA's update of the Oxera 2014 calculations suggest an optimal WACC percentile (i.e. one maximising net consumer benefits) that might sit at or above the 80th percentile.

4. Accordingly, we recommend the Commission – at a minimum – maintain the 67th percentile WACC. The Commission should also consider targeting a higher percentile to better promote the Part 4 purpose.

5. MEUG and MGUG have called for a move to the mid-point WACC percentile, both pointing to regulatory precedent as the main driver with neither presenting new expert analysis other than the evidence put forward by CEPA.

6. Oxera's reports[4] for the big six electricity distribution businesses (EDBs) and three gas pipeline businesses (GPBs) considered overseas regulatory precedent. Consistent with

[1] Oxera, WACC Percentile report
[2] CEG, report Percentile
[3] Frontier, Response to CEPA WACC report
[4] Oxera, WACC Percentile report, Asset Beta and WACC percentile for NZ GPBs

7. CEPA's findings, Oxera also noted a generalised move towards a midpoint WACC. However, Oxera explained that the move to a midpoint WACC "has tended to be accompanied by other measures that have reduced (but not eliminated) the ability for the regulated WACC to deviate from the true WACC. In the UK, for example, Ofgem has indexed movements in the risk-free rate.[5]" They also pointed out that this was not universal. For example, the French energy regulator has recently selected a WACC above the midpoint.

8. As noted in Vector's submission increased electrification of the New Zealand economy suggests a higher WACC percentile should be targeted. The cost to consumers of underinvestment has grown since the 2016 IM review.

9. Moreover, these costs are estimated under the existing 'network reliability framework' which does not account for the social costs and benefits that are affected by the delivery of net zero. This provides a further rationale to aim up for a higher percentile.

10. Since the start of the consultation period we have experienced extreme flooding followed by cyclone Gabrielle in the Auckland region. These events highlight the need for the right level of network investment to provide the resilience required in the face of climate change. Now is not the time to be changing regulatory settings that risk any under investment critical infrastructure.

<u>Financeability and indexation</u>

11. Vector shares Unison's concern that the level of investment required over the next decade poses a risk around EDBs' ability to efficiently fund future investment levels. Indexation of the regulatory asset base (RAB) suppresses cash flow at a time when significant investment is required for enhancing network reliance and delivering the electricity distribution systems required in enable decarbonisation.

12. The recent Boston Consulting Group (BCG) The Future is Electric[6] quantified the investment needed in the electricity distribution sector as $22 billion in the 2020s (2.7 times greater than the $8.2 billion estimated for Transpower).

13. We agree with Unison that applying the rationale of the approach adopted for Transpower, the necessary investment needs of EDBs justifies adjusting regulatory settings impacting on EDB financeability by:

    a. removing indexation of the RAB for all EDBs (or by EDB choice); and

    b. implementing a financeability test.

14. The ENA also recommends that the Commission investigate the benefits of allowing EDBs to choose to use an indexed, un-indexed, or partially index (hybrid) RAB. Currently airports are able to choose between being indexed or unindexed.

15. In Vector's submission to the CEPA paper we discussed the inflation forecast error. The current indexation approach requires the Commission to forecast inflation.

16. We asked Motu to refresh their memorandum to Vector explaining the difficulty inherent in forecasting inflation leading to inflation forecast error (which we have sent along with this letter).

17. Motu explains that:

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[5] Oxera, WACC Percentile report
[6] BCG, The Future is Electric – A Decarbonisation Roadmap for New Zealand's Electricity Sector, p9.

"…forecasting inflation in the 2020s is even more challenging than in the preceding decade. The unprecedented scale of monetary and fiscal policy support provided in the wake of the COVID-19 pandemic has resulted in inflation returning to levels not seen since the 1980s, to the surprise of most professional forecasters."[7]

18. Motu warns that:

"…no forecasting approach that is fixed in place while the economic and social environment is changing will be able to forecast well. Unfortunately, the current approach adopted by the Commerce Commission risks generating significant forecasting errors and is undoubtedly not fit for purpose."[8]

19. Amending the IMs to remove inflation indexation would also remove the need to forecast inflation and therefore eliminate the impact of inflation forecast error.

Yours sincerely

[redacted]

Richard Sharp
GM Economic Regulation and Pricing

[7] Motu, Update on the Difficulties of Forecasting Inflation
[8] Motu, Update on the Difficulties of Forecasting Inflation