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By email im.review@comcom.govt.nz

Input Methodologies Review 2023: CEPA report on aspects of the cost of capital

Dear Geoff

Transpower welcomes the opportunity to respond to CEPA's report on the aspects of the cost of capital input methodologies. We respond to the Commerce Commission's (the Commission's) invitation to submit views on the asset beta, WACC percentile, the Commission's methods when updating the cost of capital estimates and other aspects of cost of capital. Accompanying our submission is a report prepared for Transpower by Frontier Economics, 'Response to CEPA WACC report', in relation to the first two items.

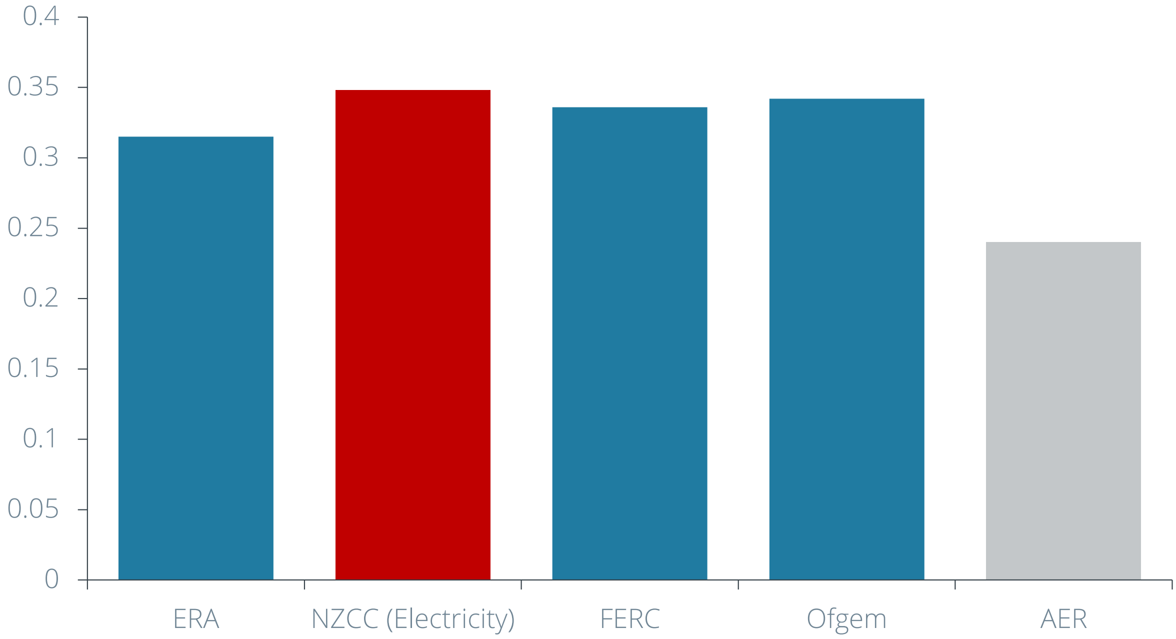
Asset beta

Transpower believes the Commission's approach to setting the asset beta is sufficiently robust. We support a statistically reliable approach and therefore agree with the selection of a large, international set of comparators. Additionally, a large sample size is more likely to produce stable estimates across regulatory periods, more likely mimicking the underlying systematic risk of an electricity lines supplier. This is further evidenced by CEPA's update, which produced an asset beta of 0.35, equal to the beta calculated in 2016.

In contrast, there is significant statistical dispersion within the individual sub-samples when assessed over (only) a 10-year period, as observed in figure 2.3 of CEPA's report.[1]

[1] CEPA "Review of Cost of Capital 2022/2023" (November 2022), page 16

We also note the Commission's asset beta estimate is in line with other comparable regulators, except for the AER, who used a sample consisting of a single firm.



Source: Frontier Economics[2]

Including delisted businesses seems counter-productive as their beta estimates would not reflect current market conditions. Any weighting of businesses by country seems like an unnecessary judgement call (subject to the usual risks of biases and goal seeking).

WACC percentile

The Commission has previously stated that "[i]n [its] view, it is appropriate to use a WACC significantly above the mid-point estimate for price-quality path regulation. This is because the potential costs of under-investment from a WACC that is too low are likely to outweigh the harm to consumers (including any over-investment) arising from a WACC that is too high."[3]

This position has consistently been reiterated and supported by expert research, for example Wright et al (2003), Dobbs (2011), Oxera (2014), and more recently Romeijnders and Mulder (2022).[4]

Transpower does not believe there is any new evidence to contradict the Commission's initial decision to set a WACC estimate above the mid-point for electricity lines businesses.

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[2] Frontier Economics "Response to CEPA report" (February 2023), page 22

[3] Commerce Commission "Amendment to the WACC percentile for price quality regulation Reasons Paper" (October 2014), page 11

[4] W Romeijnders, M Mulder "Optimal WACC in tariff regulation under uncertainty" (March 2022)

Instead, we highlight two new pieces of evidence that would strengthen the initial position:

1. CEPA's update of the Oxera's analytical framework[5], specifically the cost of a loss of network reliability; and
2. New Zealand's decarbonisation and net zero commitments and the expected increase in reliance on electricity to follow.

CEPA's updated estimate of the annualised cost of a loss of network reliability resulting from underinvestment is $1.9bn[6] (against $1.0bn in 2014). This reflects a change in electricity usage within New Zealand and an increased cost of network outages to the New Zealand economy. CEPA's update of the Oxera calculations suggest an optimal WACC percentile (i.e., one maximising net consumer benefits) that might sit at or above the 80th percentile, as illustrated by Frontier Economics[7].

The New Zealand government has set firm decarbonisation commitments which will require a significant network investment and lead to even further reliance on electricity supplied by the grid. This will also mean heightened uncertainty around the optimal level of investment required, which could have a multiplicative impact on the inherent uncertainty within the prescribed cost of capital itself.

We believe overseas precedent should be observed with caution. In the UK, we observe a lack of consistency (demonstrated by the CMA's re-determination of the Ofwat decision) and forethought (demonstrated by – the subsequently overturned – "outperformance wedge" proposed by Ofgem). In Australia, we observe no new evidence since the last IMs review.

Finally, any consideration of the cost of capital should be made alongside the entire regulatory package that runs in parallel and with reference to both dynamic and static efficiency.

The Commission's methods when updating the cost of capital estimates

At this stage have no other issues to raise in relation to the methods used to calculate the cost of capital inputs addressed in the CEPA report.

Other aspects of cost of capital

Not addressed in the CEPA report is the cost of debt. We reiterate[8] the Commission should consider the adoption of a trailing average cost of debt. A trailing average cost of debt better matches how a prudent and efficient supplier would issue and manage debt and

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[5] Commerce Commission "Amendment to the WACC percentile for price quality regulation Reasons Paper" (October 2014)

[6] CEPA "Review of Cost of Capital 2022/2023" (November 2022), page 39

[7] Frontier Economics "Response to CEPA report" (February 2023), page 10

[8] Transpower "Trailing average cost of debt and efficient debt management" (February 2016)

would help reduce volatility in transmission prices between regulatory periods. We believe all the issues raised in our last submission[9] are still worth considering.

Please do not hesitate to contact me at joel.cook@transpower.co.nz.

Kind regards,

Joel Cook

Head of Regulation

[9] Transpower submission on "Input Methodologies Review 2023: Draft Framework Paper and Process and Issues Paper" (July 2022)