



1 May 2014

Dr Mark Berry
Commerce Commission
PO Box 2351
Wellington 6140

Dear Dr Berry

Submission in relation to the Commerce Commission's Paper 'Further work on the cost of capital input methodologies'

QIC Private Capital Pty Ltd ("QIC") is pleased to provide this submission in relation to the Commerce Commission's (Commission's) consultation paper "Further work on the cost of capital input methodologies: Process update and invitation to provide evidence on the WACC percentile" (31 March 2014) (the Consultation Paper).

As you know, QIC currently manages a 58% equity interest in Powerco on behalf of its managed clients and we have held this interest in Powerco since 2009. During that time we have aimed to work constructively with the Commission, in cooperation with Powerco management, to assist in developing the new regulatory framework and we have been pleased to see the significant progress the Commission has made in this time most notably with the finalisation of the Input Methodologies (the "IMs"). We are a global investor and our most significant concern with any regulatory regime is to ensure that it provides stability and transparency. As a result we limit our investment focus to those jurisdictions where we believe the regulatory regimes are stable and transparent.

In relation to NZ, we believe the work the Commission has undertaken in the last 5 years has substantially increased the stability and transparency of the NZ regulatory regime for electricity distribution businesses and at the time of the initial investment our expectation was that the Commission would transition to a regime more consistent with its international peers. As at the end of the IMs consultation process, we believed the Commission was substantially progressed in relation to this goal and we communicated this to The Hon Bill English, Minister of Finance, in a meeting on 21 August 2013.

In relation to the current Consultation Paper, we understand that this consultation process is a direct result of the commentary in the High Court merit appeal decision on the use of the 75th WACC percentile and can appreciate the Commission's desire to be responsive to this commentary. We also understand that the High Court had expressed a view that more empirical support for use of the 75th WACC percentile was desirable, and that user groups have been publicly pushing for this empirical work to be done prior to the Commission making decisions this year on the 2015 DPP reset.

Whilst we appreciate and support the requirement for the Commission to be responsive to both the High Court and the user group's observations, we do not think this consultation process is what the High Court was seeking. In addition, we don't believe the consultation process is appropriate given it significantly reduces the stability and transparency of the NZ regulatory regime, thereby making it a less attractive



jurisdiction for international equity capital. Finally, we strongly believe that in the broader context of the existing IMs, the 75th WACC percentile is appropriate and should be retained.

Our reasons for these views are provided in further detail below.

Consultation process was not required by the High Court, instead the High Court expected that it be reviewed in the next full, formal review of the IMs in 2017

Whilst we appreciate the Commission has full autonomy to determine its response to the comments made by the High Court, we do not believe the High Court was seeking a full empirical review of the 75th WACC percentile methodology before the next formal review of the IMs scheduled to occur in 2017. In particular we note that the High Court concluded that its questions regarding empirical analysis and its tentative counter-arguments did not justify disturbing the Commission's decision. Instead, the High Court said ¹:

"...we are mindful that the IMs will be reviewed. At that time, we would expect that our scepticism about using a WACC substantially higher than the mid-point...will be considered by the Commission"

Furthermore, we note that the High Court also acknowledged that there was no empirical support for the in-principle arguments *against* using the 75th percentile nor support from independent experts. ²

Consultation process is not appropriate and undermines the stability and transparency of the NZ regulatory regime

At the time of consulting in relation to the IMs and finalising the IMs, all participants in the process provided their input on the basis that:

- Any future review of the Input Methodologies would be a complete review of all factors of the Input Methodologies, rather than discrete reviews of only certain parts in isolation; and
- That the next full review of the Input Methodologies would take place in 2017

The current consultation process is in direct conflict with the above expectation and in conflict to what we observe in other jurisdictions. Ordinarily investors in regulated assets in OECD countries have certainty for a fixed period as to the returns they can expect to receive. Ad hoc, interim reviews of key parts of the return equation significantly increase the instability of a jurisdiction and reduce the regulatory certainty. As a direct result of this, investors' perception of regulatory risk increases and the result is the exact opposite of what the High Court and the Commission are trying to achieve – required returns increase to compensate for this higher risk.

Commencing an out of cycle review of the WACC IM is a very significant step, and in itself reduces the predictability of, and confidence in, the regulatory regime. The implication in the Consultation Paper that the default setting has already changed to the median – that the WACC IM has already in substance changed unless further work performed this year restores the position - is also deeply worrying.

As an international investor and a long term investor in the New Zealand market, QIC would perceive an interim, unexpected, ad hoc review of a major return parameter (such as what the Commission is proposing in relation to the 75th WACC percentile) as a significant increase in the risk of its investment in Powerco and require a significant change to how we assess the appropriate returns required from future investment in the network. We would instead support the High Court's original expectation that any such review be

¹ Wellington International Airport Ltd and others v Commerce Commission [2013] NZHC 3289, Paragraph 1486

² Paragraphs 1472 to 1476, 1483

undertaken as part of the formal, planned review process in 2017 and furthermore that any such review be of all of the components of the IM rather than just the WACC percentile in isolation. A clarification from the Commission that these issues would be worked through as part of the review of the IMs scheduled for 2017 would be more appropriate and would not undermine the stability and transparency the Commission has worked hard to develop in the NZ regulatory regime.

From our perspective, signalling now that these issues would be worked through as part of the scheduled review of IMs would not have undermined the investment incentives that the Commission is, rightfully, looking to preserve. Investment incentives are the product of, first, the total impact of regulatory settings and, second, the predictability of change to those settings. A scheduled review of IMs every seven years is a reasonable feature in a regulatory framework.

The other aspect of the proposed process which is inappropriate is the very short timeframe provided for interested parties to provide submissions, and importantly empirical evidence, on the appropriateness of the 75th WACC percentile. Whilst there is no difficulty in providing the qualitative evidence for the appropriateness of the 75th WACC percentile, as explained in NERA's advice to Powerco the quantitative evidence is almost non-existent and a thorough analysis would require significantly more time than the one month period allowed for by the Consultation Paper. If the Commission proceeds down this path we expect it will have great difficulty in completing a robust analysis before the end of the year.

The other notable point in relation to the request for quantitative evidence is that whilst detailed quantitative evidence is not available many other leading international regulators have adopted an estimate of WACC at the high end of the range to compensate for the asymmetry of risk (e.g. Ofcom (UK); CAA (UK); and the Competition Commission (UK)).

The 75th WACC percentile remains appropriate, particularly in the context of the broader IMs and even with a detailed review should not be altered

Independent of the current consultation process, we would like to re-emphasise our strong view that in the context of the current IMs the use of the 75th WACC percentile remains appropriate. This is for the following reasons:

- The welfare impact of setting a regulated WACC too low is likely to be significantly greater than the impact of over-pricing if it is set too low (a generally accepted principle amongst international regulators);
- The 75th WACC percentile balances against the negative bias in the current WACC calculation as a result of:
 - The CAPM being proven to provide downward biased estimates of WACC (with some empirical evidence suggesting the downward bias is close to 400bps below the true required return)
 - The regulated companies having true asymmetry of returns – upside is capped at the regulated return whilst downside is unmitigated (e.g. in the event of a major natural disaster)
- Using a reference point for the cost of debt of 5-years which is below the weighted average debt maturity comparator companies use in the equity estimate, thereby introducing an inconsistency in the Commission's methodology and providing a lower WACC than required
- The Commission's own rationale for the use of the 75th WACC percentile as detailed in its *December 2010 Input Methodologies (Electricity Distribution and Gas Pipeline Service): Reasons Paper*³

³ Pages 167-168



- The fact that all investments in these regulated companies is subject to a detailed ex ante and ex post review to ensure it is appropriate and to confirm its inclusion in the allowable return
- Consistency with other leading international regulators who generally set WACC above the mid-point of the range⁴

Given our extensive experience as a global infrastructure investor, managing over A\$11 billion in 19 different direct assets across multiple jurisdictions, QIC is firmly of the view that given the numerous aspects of the NZ Input Methodology which create a downward bias in the WACC estimation (as noted above) and with reference to the Commission's own rationale, the use of the 75th WACC percentile is necessary to create a more reasonable estimate of the required return on capital in the current NZ regulatory regime. Without adjustments to numerous other parts of the WACC calculation, a reduction in the WACC percentile from 75th to 50th percentile is not appropriate – not only would it undercompensate investors for their capital it is likely to create disincentives to essential investing which, as a result of the asymmetry of risk associated with under and over investment (as discussed above), could give rise to significant social costs associated with lack of security of energy supply.

Suggested way forward

There are changes the Commission could make going forward to ameliorate these concerns yet retain investor confidence in the stability and transparency of the existing regulatory regime. As noted above it seems likely that this consultation process will highlight that the 75th percentile cannot be considered in isolation, that the empirical work envisaged will be complex and difficult to complete credibly in the time envisaged, and in any event is unlikely to be definitive. The most likely outcome in the time available is a conclusion that there is no evidence to disturb the position in the WACC IM that has been developed by the Commission and its expert advisors over many years and instead a full review will be completed as part of the scheduled review of the IMs in 2017.

It would be helpful if in the near future the Commission made a strong statement recognising the challenges of completing this consultation process this year, confirming the original basis on which it selected the use of the 75th WACC percentile and confirming that the detailed analysis will be completed as part of the scheduled review of IMs in 2017 in addition to a review of all of the other components of the IMs so as not to produce an erroneous result when assessed in isolation.

Please do not hesitate to contact myself or our director on the Powerco board, Angela Karl (a.karl@qic.com; +61 2 9347 3322) should you wish to clarify or further discuss this submission. We look forward to continuing to work with the Commission.

Yours sincerely

A handwritten signature in black ink that reads "Ross Israel".

Ross Israel

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⁴ IPART (December 2012) Review of method for determining the WACC: Dealing with uncertainty and changing market conditions: Other Industries – Discussion Paper, page 74