BARNZ
BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND INC

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Dear Brett

Invitation to comment on whether the cost of capital input methodologies should be amended

The Commerce Commission has issued a paper seeking views on whether it should review its cost of capital input methodology earlier than otherwise required.

This is primarily in response to observations made by the High Court setting out what it referred to as its 'scepticism' over whether the uplift of the WACC used in input methodologies relating to default and customised price paths from the mid-point to the 75th percentile estimate is in the long term interests of consumers.

The Court also highlighted two other issues relating to the WACC input methodologies which it recommended be reviewed, namely the continued use of the Brennan-Lally model (given the anomalous results it produces as leverage increases) and the long term credit spread differential.

In addition, the Commission itself has identified recent developments in regulatory theory and practice which could usefully be considered in any review of the WACC input methodology.

The Commission has advised that it considers it unlikely that it would be able to complete a comprehensive review of the cost of capital IM, covering all of the above issues, by November 2014. For this reason it currently favours the option of proceeding only with reviewing the WACC percentile point to be used in price quality regulation, which it believes should be able to be completed prior to the end of November this year. Completion by November this year would allow any revised IM to be applied within the reset of the EDB DPP and Tranpower's IPP which take effect in April 2015.

However, the Commission is seeking feedback on whether it should instead defer consideration of the matters raised by the Court until it reviews all input methodologies in 2017 or, alternatively, whether it should bring forward consideration of all cost of capital matters and reconsider the cost of capital IM in its entirety now.

Interests of consumers 'front and centre'

As the High Court particularly emphasised in its merits review decision, the overall or central purpose of Part 4 is to protect the long-term interests of consumers. Consumers interests, says the

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High Court, are put 'front and centre' by s52A.[1] At paragraph 761 of the merits review decision, the Court states:

> As reflected in the history of s52A that we have already outlined, the new Part 4 purpose statement was introduced to make it absolutely clear that Part 4 regulation was about protecting the long-term interests of consumers. Part 4, including s52A(1)(a), was not introduced to promote suppliers' interests. The s52A purpose statement makes it clear that in terms of incentives to invest, it is the interests of consumers in suppliers having appropriate incentives to invest that matter, not the interests of the suppliers themselves.

BARNZ considers that retaining the current IM reflecting use of the 75th percentile until 2017 when the IMs are due for review is not an approach reflecting the long term interests of consumers in accordance with the purpose statement in s52A. It will result in consumers potentially paying charges hundreds of millions of dollars greater than necessary across all regulated industries – for no discernable benefit. BARNZ is fundamentally opposed to the option of deferring further consultation on the WACC IM until 2017. As was noted by the High Court:[2]

- Use of the 75th percentile WACC estimate for setting default and customised pricing paths involves the likelihood that suppliers will earn excess returns – contrary to the s52A(1)(d) objective of ensuring suppliers are limited in their ability to extract excessive profits.
- The prospect of earning a normal return on new investment should be a sufficiently attractive proposition to provide appropriate incentives for investment.
- Allowing higher than normal expected returns to be earned is likely to create inefficiencies and not incentivise invention, innovation or the need to strive for efficiency.
- Allowing higher than normal expected returns to be earned is likely to lead to wasteful investment.
- Applying a higher than normal WACC estimate to past investments is unlikely to be necessary to promote incentives to undertake future investment and innovation.

BARNZ considers that the Commission needs to move now to review the issue raised by the High Court that the input methodology providing for the 75th percentile WACC estimate to be used in DPP and CPP decisions does not protect the long-term interests of consumers, in that it allows regulated suppliers to extract excessive profits at levels which are significantly greater than is necessary in order to provide appropriate incentives to innovate and invest.

BARNZ's preference would have been for the Commission to have reviewed all current issues in relation to the cost of capital IM at the present time. However, as the Commission considers that this is not possible to achieve in time for any revised IM to be reflected in the next reset DPP and CPP decisions, BARNZ supports the Commission moving to consult now on the limited scope of amending the WACC percentile to be used in price-quality regulation.

Yours sincerely,

John Beckett, Executive Director

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[1] See for example para 165, 665, 686, 761 and 1461.

[2] Refer para 1460 – 1486.