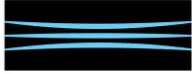

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13 March 2014

Brett Woods
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By email: regulation.branch@comcom.govt.nz

Dear Brett,

Consultation on whether the Commission should review the cost of capital input methodologies

Thank you for the opportunity to comment on the paper "*Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies",* published 20 February 2014. No part of our submission is confidential.

The Commerce Commission is rightly concerned about promoting regulatory certainty and predictability. This objective would be harmed by embarking on an accelerated review of the cost of capital input methodology, because:

1. a fast-tracked review of a matter as fundamental as the cost of capital methodology would be contrary to the policy objective of establishing a stable, predictable regulatory environment
2. a comprehensive and robust review could not be completed before November this year, while a review focussing solely on the estimation percentile would be too narrow and reactive (and also unlikely to be completed within six months)
3. the Court deliberately decided not to amend the cost of capital methodology, and commencing a regulatory review before the outcome of any appeal process is known would only add uncertainty
4. the Commission's original rationale is consistent with regulatory precedent from "benchmark" regulators overseas and is supported by empirical evidence and economic theory.

We address each of these matters in turn below. We also attach responses to the Commission's consultation questions and report from Frontier Economics (March 2014): *Evidence in support of setting allowed rates of return above the midpoint of the WACC range* that briefly reviews the analytical basis for the Commission's adoption of a 75th percentile WACC and its consistency with regulatory best practice. By necessity this report was prepared within a short timeframe and therefore is not comprehensive.

A fast-tracked review would be counter to the Commission's policy objectives

The Commission has expressed the need to promote regulatory certainty and predictability. A fast-tracked review of the cost of capital methodology, especially in the middle of the first

full reset process for Transpower and electricity distribution businesses, would undermine the stability, predictability and certainty that the Commission seeks to promote.

The 2007 Cabinet paper recommending the current Part 4 regime described the role of input methodologies as follows:

> The discussion document proposed that "input methodologies" be set in an up-front stand-alone process at the start of inquiries and any set or re-set of price/quality paths. The purpose is to give greater certainty, transparency and predictability to businesses (including businesses not subject to regulation) and their customers. Virtually all submitters, including the Commission, endorsed the proposal.[1]

The Cabinet paper also stated that:

> The changes are expected to improve business confidence and, as a consequence, improve the climate for investment in infrastructure.[2]

These passages neatly highlight the broad policy objective of establishing a stable, predictable regulatory regime supporting a climate in which businesses have confidence to invest in the infrastructure services that support the New Zealand economy. To promote this objective, the Commission should have a preference for reviewing fundamental value-shifting aspects of the input methodologies[3] (IMs) only:

- infrequently, to support stability
- when well signalled in advance, to support predictability
- together with related input methodologies, to support the integrity of the regulatory regime
- when the Commission, and interested parties, have the time and resources available to support a complete, robust and unhurried review process.

The Commission should only depart from these preferences when directed by the High Court. The High Court was mindful that the IMs would be reviewed and expressed the view that *at that time* the Commission should consider its comments[4]. Although High Court had the option to do so it did not instruct the Commission to change the WACC or to initiate a review ahead of the signalled timetable for the statutory review.

In practice, the input methodologies have not had their first scheduled review yet and we remain in a period where the regulatory framework is bedding in. While the Commission has done well to establish the IMs it must be mindful that predictability and certainty are as much a product of the regulator's behaviour as they are of the codified rules. In other words, the manner in which the Commission exercises its discretion on issues such as this will, as much as the codified rules, determine the certainty and predictability that the overall regime provides. In that context the entry thresholds described above for IM reviews are particularly critical.

[1] *Cabinet Paper: Review of Parts 4 and 4A of the Commerce* Act, 2007, paragraph 32

[2] *ibid*, paragraph 7

[3] We note that not all aspects of the input methodologies need to be treated the same. For example, we do not see any business confidence issues related to our request to allow part year depreciation for assets in the year of commissioning.

[4] Paragraph 1486 of the High Court judgement

There is not enough time to complete a full review, and the 75th percentile issue cannot be considered in isolation

The Commission is correct to view consulting solely on the potential amendment of the WACC percentile as sub-optimal and to favour a comprehensive review. There are many good reasons for this, including those stated by the Commission in this consultation paper and in other contexts[5]. Those reasons are, in a nutshell, that the IMs need to be considered 'as a package' and that consideration of one issue in isolation risks missing important broader context that may influence that decision. This is both good regulatory practice and common sense.

However, we agree with the Commission's conclusions that a comprehensive and robust review is unlikely to be possible within the next six months. Cost of capital is a contentious regulatory issue, it is technically complex, requires specialist input and there is no demonstrably 'ideal' answer. In reality, such a review would require a multi-stage process of consultation, workshops, draft and final decisions that is likely to span a full year or more.

Any review of the WACC input methodologies should be on a comprehensive basis, considering all aspects of how the WACC is determined. It should not be limited to matters that could reduce the WACC – especially because adoption of the 75th percentile provides an important safeguard against the risk of under-estimating the true cost of capital (and there are concerns that the regulatory WACC is already too low[6]).

It follows that any review of the WACC should include all aspects of the WACC IMs and be undertaken at a point in time and to a timetable that are conducive to a robust outcome. We also consider that, as well as the application of WACC under Part 4 of the Commerce Act the Commission should be mindful of its application under Part 2 of the Telecommunications Act.

The High Court has not created heightened uncertainty

While investors seek certainty and predictability, they accept that conditions change over time and that regulatory settings evolve. What is critical is that signals given by the regulator can be relied upon and that the process by which it makes decisions imparts confidence that a valid outcome will result. A change to any of the WACC parameters is a possible outcome of the section 52Y review scheduled for 2016-2018, regardless of the High Court judgment.

Our view is that the comments made in the judgement do not heighten uncertainty above normal 'ambient' levels. On the contrary, the High Court judgment provided guidance as to the type of evidence that may be useful in making a decision about whether to change the WACC IMs. This allows interested parties to better prepare for the review and to specifically address the issues identified by the High Court and ensure that the Commission has the evidence it needs to make an informed decision.

That the High Court judgement provides increased (not decreased) certainty appears consistent with the outcome expected by the Cabinet paper - which recommended that the merits appeals be heard by the High Court, in large part because this would *"…minimise the risk of further appeals and reviews…"*[7].

Adopting a 75th percentile (or higher) WACC estimate is consistent with best practice

It is not correct to characterise the approach as "providing regulated suppliers an uplift to ensure investment"; as "providing an abundance of capital"; or as "guaranteeing an excess

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[5] For example: Commerce Act Part 4 Funding Review, Commerce Commission discussion document.

[6] For example, Dr Lally indicated that the 75th percentile should be viewed as a minimum; Chorus and Vodafone view, in submissions to the UCLL TSLRIC consultation that current Part 4 WACC determinations are too low.

[7] *Cabinet Paper: Review of Parts 4 and 4A of the Commerce* Act, 2007, paragraph 36.

return". Rather, the 75th percentile approach reduces the risk that the regulatory WACC is lower than a supplier's true WACC and, in so doing, reduces the risk of underinvestment in network infrastructure (with the associated societal costs).

The consultation paper suggests this is a question of empirical evidence versus assertion. This is incorrect. Different types of evidence (i.e. not just empirical) supports the practice of adopting an estimate. We asked Frontier Economics to comment on the analytical basis for the Commission's current position and its consistency with regulatory best practice, as exhibited by benchmark regulators. The Frontier Economics report concludes:

> Our main findings are the following:
>
> - There is strong **conceptual** support, from standard economic theory and the characteristics of electricity networks, for the Commission's approach and rationale.
> - The main source of **empirical** evidence on this issue is from studies that use simulation modelling to evaluate the optimal allowed rate for return, given the welfare consequence trade-offs articulated by the Commission. The Court and other parties have referred to this as the 'loss function approach'. The most comprehensive and germane of these studies that we know of is strongly supportive of the Commission's approach of setting allowed rates of return well above the midpoint of the WACC range.
> - Despite the limited evidence adduced before the Court, there is strong evidence of a broad **acceptance by regulators and policymakers overseas** (e.g. in Great Britain and Australia) that the social harm of setting the allowed rate of return too low likely outweighs the social harm from setting it too high. The Commission's approach of adopting the 75th percentile of the WACC range is very much in line with accepted regulatory practice.

Therefore, the application of a 75th percentile estimate of the median WACC provides a critical safeguard for ensuring regulated suppliers are able to earn a commercially-sustainable (normal) rate of return and, in turn, for ensuring regulated suppliers have the incentives and ability to invest (s 52A (1) (a)), and provide services at a quality that reflects consumer demands (s 52A (1) (b)). Use of a 75th percentile estimate is also consistent with ensuring regulated suppliers have limited ability to extract excessive profits (s 52A (1) (d)). The Commission should be cautious about pursuing the objective in subpart s 52A (1) (d) at the expense of s 52A (1) (a) and (b).

Finally, we encourage the Commission to bear in mind the resource implications of any WACC review for itself and affected parties in what is clearly a peak year for parties affected by Commerce Act and Telecommunications Act regulation. Please let me know if you would like clarify or discuss any of the points made in this submission.

Yours sincerely

Ross Parry
Planning and Regulatory Manager

Appendix A: responses to specific questions

Commission question	Transpower response
1. Are the positive incentives provided by using the 75th percentile WACC significantly weakened until we address the concerns raised by the Court?	No. While investors seek certainty and predictability, they accept that conditions change over time and that regulatory settings evolve. What is critical is that signals given by the regulator can be relied upon and that the process by which it makes decisions imparts confidence that a valid outcome will result. A change to any of the WACC parameters is a possible outcome of the section 52Y review scheduled for 2016-2018, regardless of the High Court judgment. Our view is that the comments made in the judgement do not heighten uncertainty above normal 'ambient' levels. On the contrary, the High Court judgment provided guidance as to the type of evidence that may be useful in making a decision about whether to change the WACC IMs. This allows interested parties to better prepare for the review and to specifically address the issues identified by the High Court and ensure that the Commission has the evidence it needs to make an informed decision. That the High Court judgement provides increased (not decreased) certainty appears consistent with the outcome expected by the Cabinet paper - which recommended that the merits appeals be heard by the High Court, in large part because this would *"…minimise the risk of further appeals and reviews…*[8]*"*.
2. Should we bring forward a review of the cost of capital IMs?	No. We understand why the Commission decided to consult on this issue and understand why, in the abstract, the option of proceeding only with the WACC percentile issue may be appear to be attractive[9]. On one hand there is ample evidence that the Commission's adoption of a 75th percentile WACC is currently consistent with economic theory and best practice regulation. On the other, these processes rarely adhere to initial timetables. Even where they are generous, it seems particularly unlikely this will be the case here and difficult to see how the percentile issue can be dealt with discretely. However, a fast-tracked review of the cost of capital methodology, especially in the middle of the first full reset process for Transpower and electricity distribution businesses, would undermine the stability, predictability and certainty that the Commission seeks to promote. The 2007 Cabinet paper recommending the current Part 4 regime

[8] *Cabinet Paper: Review of Parts 4 and 4A of the Commerce* Act, 2007, paragraph 36.

[9] Identified as the Commission's preferred option at 51.3 (but not elsewhere in the paper)

Commission question	Transpower response
	described the role of input methodologies as follows: > The discussion document proposed that "input methodologies" be set in an up-front stand-alone process at the start of inquiries and any set or re-set of price/quality paths. The purpose is to give greater certainty, transparency and predictability to businesses (including businesses not subject to regulation) and their customers. Virtually all submitters, including the Commission, endorsed the proposal.[10] The Cabinet paper also stated that: > The changes are expected to improve business confidence and, as a consequence, improve the climate for investment in infrastructure.[11] These passages neatly highlight the broad policy objective of establishing a stable, predictable regulatory regime supporting a climate in which businesses have confidence to invest in the infrastructure services that support the New Zealand economy. To promote this objective, the Commission should have a preference for reviewing fundamental value-shifting aspects of the input methodologies[12] (IMs) only: • infrequently, to support stability • only when well signalled in advance, to support predictability • together with related input methodologies, to support the integrity of the regulatory regime • only when the Commission, and interested parties, have the time and resources available to support a complete, robust and unhurried review process. The Commission should only depart from these preferences when directed by the High Court. The High Court was mindful that the IMs would be reviewed and expressed the view that *at that time* the Commission should consider its comments[13]. Although High Court had the option to do so it did not instruct the Commission to change the WACC or to initiate a review ahead of the signalled timetable for the statutory review.

[10] *Cabinet Paper: Review of Parts 4 and 4A of the Commerce* Act, 2007, paragraph 32

[11] *ibid*, paragraph 7

[12] We note that not all aspects of the input methodologies need to be treated the same. For example, we do not see any business confidence issues related to our request to allow part year depreciation for assets in the year of commissioning.

[13] Paragraph 1486 of the High Court judgement

Commission question	Transpower response
3. If not, should we consider an amendment to the cost of capital IMs solely of the 75th percentile WACC estimate used for setting price-quality paths?	No. The Commission is correct to view consulting solely on the potential amendment of the WACC percentile as sub-optimal and to favour a comprehensive review. There are many good reasons for this, including those stated by the Commission in this consultation paper and in other contexts[14]. Those reasons are, in a nutshell, that the IMs need to be considered 'as a package' and that consideration of one issue in isolation risks missing important broader context that may influence that decision. This is both good regulatory practice and common sense. However, we agree with the Commission's conclusions that a comprehensive and robust review is unlikely to be possible within the next six months. Cost of capital is a contentious regulatory issue, it is technically complex, requires specialist input and there is no demonstrably 'ideal' answer. In reality, such a review would require a multi-stage process of consultation, workshops, draft and final decisions that is likely to span a full year or more. Any review of the WACC input methodologies should be on a comprehensive basis, considering all aspects of how the WACC is determined. It should not be limited to matters that could reduce the WACC – especially because adoption of the 75th percentile provides an important safeguard against the risk of under-estimating the true cost of capital (and there are concerns that the regulatory WACC is already too low[15]). It follows that any review of the WACC should include all aspects of the WACC IMs and be undertaken at a point in time and to a timetable that are conducive to a robust outcome. We also consider that, as well as the application of WACC under Part 4 of the Commerce Act the Commission should be mindful of its application under Part 2 of the Telecommunications Act.
4. Is there any other option that avoids the risk of locking in higher prices for electricity consumers, if we were to later conclude that the uplift should be reduced or is not	In the near term the fact that, if successful, MEUG's appeal will result in claw-back of any over (or under) recovery sufficiently addresses the Commission's concern. In the medium term, the fact that the Commission is required to regularly review all the IMs ensures any material problems in the cost of capital (or any other aspect of the input methodologies) can be addressed. At a more general level we are concerned this question pre-supposes that the options available to the Commission are 75th percentile WACC and/or adoption of a lower percentile WACC. We remind the Commission of the view expressed by Dr Lally at the Cost of Capital Workshop that "the 75th percentile is probably

[14] For example: Commerce Act Part 4 Funding Review, Commerce Commission discussion document.

[15] For example, Dr Lally indicated that the 75th percentile should be viewed as a minimum; Chorus and Vodafone view, in submissions to the UCLL TSLRIC consultation that current Part 4 WACC determinations are too low.

Commission question	Transpower response
warranted?	the lower bound on what you might want to choose.” [at para 1446, High Court judgment] It is also worth bearing in mind that the purpose in Part 4 of the Commerce Act includes (at s 52A (1) (d)) that regulated suppliers should be limited in their ability to extract excessive profits, rather than that possibility of excessive profits should eliminated or excluded altogether particularly as that elevates the risk of under-recovery and the associated costs of under-investment.
5. What evidence is there in support of either the 75th percentile or credible alternatives?	We do not agree with the High Court judgment that there is no analysis or empirical evidence justifying use of the 75th percentile WACC. This is incorrect. There is a large amount of evidence in support of a 75th percentile WACC, or higher. We refer the Commission to the attached Frontier report which specifically addresses this point. The Commission [at para 1437] “… drew attention to two decisions of the United Kingdom Competition Commission to use estimates above the mid-point for WACC or regulated airports.” The High Court [at para 1436] noted that “In December 2008, when Dr Lally recommended that the Commission choose a point higher than the mid-point, Professors Myers and Franks agreed that the Commission should set the WACC equal to or greater than the mid-point … The advice was, however, expressed in very conclusionary terms and neither Professors Myers nor Franks, nor Dr Lally explained their reasoning in any detail.” A useful starting point for the Commission, in considering what evidence there is to support a 75th percentile WACC, would be to request Professors Myers and Franks, and Dr Lally provide their reasoning in support of the use of a 75th percentile WACC. We also refer the Commission to some of its own reasoning. We agree with the Commission that “there are higher costs in under-estimating the price than over-estimating the price (i.e., asymmetric costs)”[16] and “the risk to dynamic efficiency of a low access price is asymmetric and that the balance of risk favours setting a price that errs on the high side. Consequently, we believe some adjustment is appropriate to take account of asymmetric risks.”[17] While these statements were made in relation to Unbundled Bitstream Access pricing, we agree with Vector that “this position is valid for both Part 2 of the Telecommunications Act and Part 4 of the Commerce Act.”[18]
6. In selecting an	Reference to regulated outputs being inputs to other sectors of the

[16] Para 10, Commerce Commission, Unbundled Bitstream Access Service Price Review, 5 November 2013.
[17] Paragraph 231, ibid.
[18] Paragraph 4, Vector, Submission to the Commerce Commission on the Scoping and Issues Discussion Paper for UCLL TSLRIC, 14 February 2014.

Commission question	Transpower response
appropriate WACC percentile, how significant is it that regulated outputs are inputs to other sectors of the economy?	economy is essentially a rephrased subset of "long-term benefit of consumers". The High Court narrowly considered the impact of the prices for regulated services on other sectors of the economy, without considering the interrelationships amongst price, service quality and investment. When considering the impact of the Part 4 decisions on consumers, and other sectors of the economy, the Commission faces the same trade-off between the benefit to consumers of a lower price and the benefit of ensuring regulated suppliers have both incentives and the ability to invest and maintain their networks, and to provide services at a quality that reflects consumer demands. We urge the Commission to ensure it does not place over emphasis on achieving s 52A(1)(d), of the purpose in Part 4 of the Commerce Act, at the expense of s 52A(1)(a) – (c). A risk that could arise is that consumers benefit from lower prices in the shorter-term, but that consumers and New Zealand business suffer from sub-optimal investment in infrastructure. This provides a stark trade-off between allocative efficiency and dynamic efficiency and highlights the critical role of the Commission in balancing the short and long term interests of consumers. It is vital to the New Zealand economy, and New Zealand businesses, that network infrastructure – be it electricity, gas, telecommunications, roads etc. – is well maintained, and there is sufficient investment to maintain and enhance service quality. We note this is recognised in the New Zealand National Infrastructure Plan which sets out a vision that "By 2030 New Zealand's infrastructure is resilient and co-ordinated and contributes to economic growth and increased quality of life." The Plan also recognises that "Infrastructure is critical to all aspects of modern living, allowing us to enjoy the quality of life we have become accustomed to and providing a platform that enables us to compete in the global economy". The first Plan, published in 2010, notably signalled the Government's intention to deliver large scale investment in key infrastructure priorities which, notably, included electricity transmission. Transpower considers that this supports the Commission's adoption and retention of a 75th percentile WACC, or an above 75th percentile WACC. Consideration of the importance of infrastructure to the economy also supports the Commission's view that "there are higher costs

Commission question	**Transpower response**
	in under-estimating the price than over-estimating the price (i.e., asymmetric costs)"[19] and "the risk to dynamic efficiency of a low access price is asymmetric and that the balance of risk favours setting a price that errs on the high side. Consequently, we believe some adjustment is appropriate to take account of asymmetric risks."[20]

[19] Para 10, Commerce Commission, Unbundled Bitstream Access Service Price Review, 5 November 2013.

[20] Paragraph 231, ibid.