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Keston Ruxton
Manager, Market Assessment and Dairy
Regulation Branch
Commerce Commission
Wellington

By email: im.review@comcom.govt.nz

Dear Keston,

Input methodologies review – update paper on the cost of capital topic

- 1 Vector has reviewed the ENA's submission and the accompanying expert reports provided by CEG. Other than as we set out below Vector supports the ENA submission and CEG's observations about the current short-comings with the Commerce Commission's (the Commission) current weighted cost of capital (WACC) Input methodology (IM) and its recommendations for improving the WACC IM.

Issues with applying for a customised price-path (CPP)

- 2 As acknowledged by the Commission, the current WACC IM gives rise to very volatile changes to the estimate of WACC from year to year. Such volatile changes to the estimate of WACC would apply to any CPP application made during the year. Accordingly, WACC becomes a meaningful consideration, and potentially a disincentive or incentive, for businesses wishing to apply for a CPP.
- 3 However, Vector does not support the ENA's recommendation of making a CPP WACC equal to the prevailing DPP WACC. Rather, Vector believes the most important issue for the IM review is to address the causes of volatility within the WACC IM. Vector supports improvements recommended by CEG to the WACC IM such as moving to a 10 year government bond, removing the volatility of 'prevailing' estimates, moving to a trailing average cost of debt and applying an internally consistent approach to the estimate of cost of equity risk-free-rate and tax-adjusted market risk premium to ensure the Commission's estimate of WACC is much more durable over time.
- 4 Once such improvements have been made to the WACC IM, Vector considers the recalculation of WACC for a CPP application becomes a much less significant issue.

Removing inflation forecasting risk from the IMs

- 5 Vector does not support the Commission's position that the WACC is a "natural hedge" to the forecast indexation of the RAB as this only supposedly delivers a real return. The IMs must have as their purpose and deliver in their application a nominal return to businesses, free of inflation forecasting errors.

- 6 Accordingly, Vector endorses CEG's suggestion in its expert report for the ENA *Inflation: revaluations and revenue indexation* (the CEG expert report) that delivering a nominal return could be better achieved simply by not applying any CPI related revaluations in the Commission's financial model nor in the RAB roll-forward. To this end, Vector supports "option 2" in Table 1 of CEG's expert report as being the most effective and least costly method of ensuring regulated businesses achieve a nominal return free of inflation forecasting errors. Vector supports reforms to the IMs that provides regulated businesses with choice as to how they are nominally compensated (whether they prefer contemporaneous CPI compensation or backloaded). Such reforms should reduce the risk of inflation forecasting error currently embedded in the IMs.
- 7 The impact of inflation forecasting is also relevant for estimating the 'CPI element of the price path'. Vector notes the impact of errors in inflation forecasting does have implications on establishing the correct starting maximum allowable revenue (MAR). Vector supports reform to the IMs to address the issue that at present businesses are unable to achieve a nominal return due to price CPI element forecast errors. Vector recommends that regulated businesses be compensated in full for differences between out-turn CPI and the forecast CPI used by the Commission in establishing starting MAR.
- 8 If you have any further questions in relation to this submission please contact Kelvin Binning on 09 213 1542 or Kelvin.Binning@vector.co.nz.

Yours faithfully
For and on behalf of Vector Limited



Richard Sharp
Head of Regulatory