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Dear Keston

Consultation on the cost of capital for the UCLL and UBA price reviews

Thank you for the opportunity to comment on submissions received by the Commerce Commission on its technical consultation paper "Determining the cost of capital for the UCLL and UBA price reviews" (7 March 2014).

As we noted in our letter of 28 March 2014 this is a very significant consultation for the telecommunications industry. We appreciate the fact that the Commission has engaged on this topic.

We attach an expert report from Dr Hird of the Competition Economists Group that responds to submissions on two points.

The first is the cost of debt. There is a good degree of consensus in submissions that the regulated cost of capital should include the efficient cost of debt for a provider of the services in question. Where views diverge is on how the efficient cost of debt should be estimated. Dr Hird highlights that the approach he explained in Section 5 of his 28 March 2014 report best reflects empirical data on efficient practice, and also the practice of regulators in other jurisdictions.

The second issue is the setting of the estimate of the cost of capital at the 75th percentile of the range produced by the CAPM model. Dr Hird emphasises that submitters do not often recognise there are two reasons for doing so. The first relates to risks not compensated elsewhere in the model. As these risks are not recognised elsewhere, use of the median WACC means expected returns to investors in reality will be below the median – an outcome contrary to the regulatory objective. As Enable Services emphasised in its submission, this is an issue particularly prominent in telecommunications markets.

The second rationale for adopting the 75th percentile is the expected asymmetric social consequences of under versus overcompensating investors. Dr Hird refutes the suggestion that the case for this is weaker in telecommunications.

Yours faithfully,

Vanessa Oakley
General Counsel and Company Secretary