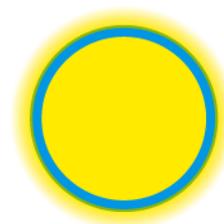


13 March 2014

John Hamill  
Commerce Commission  
Wellington  
PO Box 2351  
WELLINGTON 6140

[Sent by email to: [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)]



Dear John

**RE: Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital methodologies**

This letter responds to your request for initial thoughts on the Commerce Commission's (the Commission) recent 'Invitation to have your say' paper on whether it should review or amend the cost of capital input methodologies (the Invitation paper).<sup>1</sup> Powerco supports the submission made by the Electricity Networks Association.

The Commission's paper follows the recent High Court decision<sup>2</sup> on the merits appeal against the input methodologies (IMs), including those for the cost of capital.

The Invitation paper seeks submissions on six questions, viz.:

1. Is there any other option that avoids the risk of locking in higher prices for electricity consumers, if we were later to conclude that the uplift should be reduced or is not warranted?
2. If not, should the Commission consider an amendment to the cost of capital IMs solely of the 75th percentile WACC estimate used for setting price-quality paths?
3. Are the positive incentives to invest provided by using the 75th percentile WACC significantly weakened until we address the concerns raised by the Court?
4. Should the Commission bring forward a review of the cost of capital IMs?
5. What evidence is there in support of either the 75th percentile or credible alternatives? and
6. In selecting an appropriate WACC percentile, how significant is it that regulated outputs are inputs to other sectors of the economy?

**General comments**

As a general comment we do not believe that a review of the WACC IM is appropriate at this time and proceeding with an out of cycle review of one aspect of the IM will create, rather than reduce, regulatory uncertainty. In fact, unnecessary uncertainty for investors has been created directly as a result of the Commission signaling the prospect of an ad hoc review of the WACC IM outside the intended IM review cycle. This view is shared by Powerco's shareholders, QIC and AMP Capital, both of whom are experienced international investors in infrastructure assets.

<sup>1</sup> *Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies*, Commerce Commission, 20 February 2014.

<sup>2</sup> *Wellington International Airport Ltd and Ors v Commerce Commission* [2013] NZHC, 11 December 2013.

To ensure that Powerco's position on this issue is clear, the following points are highlighted as relevant to any decision by the Commission to review the WACC IMs at this time:

- The use of the 75<sup>th</sup> percentile should not be treated as a narrow technical issue and cannot be looked at in isolation. It is not solely a question of allowing for the asymmetric costs of error, severable from the remainder of the WACC calculation. There are clear interdependencies between the 75th percentile question and other aspects of the cost of capital IMs. This is made clear by the reasons the Commission has given for adopting the 75<sup>th</sup> percentile,<sup>3</sup> and is consistent with the practice of regulators in other jurisdictions.
- A recent comment made by the Commission in its final reasons paper on the Orion CPP application illustrates this point<sup>4</sup>:

*“..although the IMs do not make any explicit adjustments to the cost of capital (or provide additional cash-flow allowance) for asymmetric risk, the practical effect of using the 75<sup>th</sup> percentile WACC is to provide a buffer for catastrophic events.”*
- The criticism by the Court of the Commission's decision-making did not properly acknowledge the multiple reasons for adopting the 75<sup>th</sup> percentile, and focused on a perceived shortfall in empirical support for the decisions made from economic principles. Given the interdependencies with other components of the WACC calculation, developing an evidenced based approach to this analysis is unlikely to be a trivial task. We agree with the Commission's view that completing a rigorous analysis will not be practicable in the timeframe available to the DPP price reset in 2014;
- In the absence of the evidence referred to by the Court, the Commission should take confidence from the fact that its experts (Lally, Myers and Franks) agreed, after lengthy deliberations, on a point estimate above the mid-point;
- Other input components to the WACC remain contentious. There are strongly held perceptions of bias (up or down) in those parameters, and therefore considering the issue of the 75<sup>th</sup> percentile in isolation will be contentious in itself;
- The Court said [para 1486] “...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.” [emphasis added];
- The Court has not provided any indication to the Commission that the review of the WACC IMs should be brought forward from the previously signalled date of late 2017;
- The fact of a review in 2017 does not create regulatory uncertainty or undermine investment incentives. Investors expect that review to work through all relevant issues in a way that recognises interrelationships, on a timetable that allows for proper consideration, and guided by an objective of setting a fair rate of return;
- Reviewing the WACC IMs on one significant matter, outside of the expected regulatory cycles, creates significant regulatory uncertainty and would likely result in a severe loss of confidence in the Part 4 regime overall; and,
- It would be inappropriate to initiate a procedural review of the WACC IMs at this time, whilst the matter is before the Courts and the High Court's judgment is subject to ongoing appeal applications.

In the remainder of this letter we set out a summary of the Commission's questions and preliminary positions, and our initial comment on the best approach to address them.

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<sup>3</sup> *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, Commerce Commission December 2010, paragraph H11.54.

<sup>4</sup> *Setting the customised price-quality path for Orion NZ Ltd – Commerce Commission Final reasons paper*, 29 November 2013, paragraph C25, p. 142.

## 1 Are there other options that would address the Court's concerns?

### **Commission position**

- The Commission notes that the price-quality paths for EDBs and Transpower are to be locked in as part of the final price path determinations in 2014 and so, if adopting a 75th percentile WACC overstates the cost of capital, not changing it before November 2014 would mean that businesses would be overcompensated for the next five years.
- The Commission is seeking submissions on whether there are other options for addressing the Courts concerns.

### **Powerco comment**

- An important task of regulators is to communicate to the wider community the reasons for their decisions, including those relating to the cost of capital.
- It would be helpful if the Commission were to reiterate and expand on its previous explanations that estimating the cost of capital (especially the cost of equity) is an imprecise exercise and that the Commission's preferred approach, previously consulted on at length, has a number of recognised weaknesses that cause the cost of capital to be underestimated. For example, the CAPM underestimates the required return on low beta stocks.
- In the context of the above, the Commission should also expand on its particular previous explanations, and the views of its experts, in support of the selection of the 75th percentile, and specifically why this has an important function in ensuring that private businesses invest sufficient capital to provide essential services such as electricity, gas, and aeronautical services.
- Setting out the Commission's previous positions would address the Court's immediate concerns by communicating the reasons that the 75th percentile does not over compensate regulated businesses, and help establish why a review of the WACC IMs at this time is unnecessary.

## 2 Should the Commission consider an amendment to the cost of capital IMs solely of the 75th percentile WACC estimate used for setting price-quality paths?

### **Commission position**

- The Commission asks for submissions on whether it should consider a review focused solely on whether or not to amend the 75th percentile element of the IMs.
- Importantly, the Commission notes that the Court considered the question about the 75th percentile WACC estimate to be separable from that of whether the rest of the WACC calculations were "right", i.e. free from bias.
- The Commission has indicated a preliminary view that, despite the fact there could be relevant inter-dependencies between the use of the 75th percentile and other aspects of the cost of capital IMs, these could be addressed by reasonableness checks on the WACC estimate.

### **Powerco comment**

- A piecemeal adjustment to the IMs creates considerable risk;
- Powerco does not accept the premise that the adoption of the 75th percentile WACC estimate is separable from the question of whether or not the other elements of the WACC calculations were "right". In its 2010 IM Reasons Paper<sup>5</sup>, the Commission noted that the precise percentile estimate of the cost of capital was informed by a number of factors, including:

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<sup>5</sup> *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, Commerce Commission December 2010, paragraph H11.54.

- The risk that the true (but unobservable) cost of capital is above the estimated mid-point WACC;
- the risk that CAPM and the simplified Brennan-Lally CAPM may underestimate the returns on low beta stocks;
- the impact on potential subsequent investment by service users and the potential impacts on dynamic efficiency;
- considering the risk of error in estimating individual parameters of the simplified Brennan-Lally CAPM, including beta and the TAMRP, for example, the Commission has considered the risk that the values for some parameters may be above their true (but unobservable) level including, for example, the estimated asset beta and debt issuance costs;
- We also note that it is highly relevant that the setting of a rate of return above the mid-point (or average) of a WACC range is a common regulatory practice elsewhere, but is achieved through a variety of means, for example,
  - The Australian Energy Regulator determines an equity beta range of 0.4 to 0.7 but adopts a value of 0.7 to determine the cost of equity<sup>6</sup>;
  - Ofgem (the UK energy regulator) moved away from using current averages of gilt (government bond) yields, and has instead relied on what it describes as very long-run averages for the risk-free rate, the effect of which is to increase the allowed WACC<sup>7</sup>;
  - Ofwat (the UK water regulator) chose an estimate at the top of the range recommended by its advisers, while using long-run estimates of the risk-free rate<sup>8</sup>;
  - CAA (the UK aviation regulator) adopted an approach that included an uplift to total market returns (i.e. the sum of the risk-free rate and the ERP) relative to long-run normal conditions<sup>9</sup>; and
  - EMVI (the Finnish energy regulator) adopted an estimate of the rate of inflation capped at 1 per cent (which was significantly lower than actual inflation at the time), which essentially amounted to an uplift to the cost of equity;
- There are legitimate concerns about the empirical validity of the CAPM which also highlight the importance of accounting for uncertainties in parameter estimates and for selecting a point estimate of WACC above the mid-point, for example,
  - A number of studies that have found that estimates of the cost of equity derived from the CAPM do not closely match observed returns;
  - the CAPM underestimates the return on low beta stocks and overstates the return on high beta stocks;<sup>10</sup>
  - factors other than beta have been found to explain the observed returns;
  - the simplified Brennan-Lally CAPM implicitly overstates the value of distributed franking credits and, consequently, also underestimates the cost of equity; and
  - the use of a five year risk-free rate will also underestimate the WACC.
- For the reasons noted above we strongly disagree with the Commission's preliminary view that relevant inter-dependencies between the 75th percentile and other aspects of the cost

<sup>6</sup> AER(2013) *Better Regulation – Explanatory Statement Rate of Return Guideline*.

<sup>7</sup> Ofgem (2012) *R110\_GD1 Initial proposals Supporting Document: Finance and Uncertainty*.

<sup>8</sup> Ofwat (2009) *Future water and sewerage charges 2010-15, Final determinations*.

<sup>9</sup> CAA (2010) NATS (En Route) plc price control: *CAA formal proposals for control period 3 (2011-2014) under section 11 of Transport Act 2000*.

<sup>10</sup> A point recently recognised by the Australian Energy Regulator, see AER (2013) *Better Regulation – Explanatory Statement Rate of Return Guideline*.

of capital IMs could be addressed solely by reasonableness checks on the WACC estimates.

### **3 Are the positive incentives to invest provided by using the 75th percentile WACC significantly weakened until we address the concerns raised by the Court?**

#### ***Commission position***

- The Commission is concerned that the High Court's judgment has created at least some expectation that the cost of capital IM will sooner or later be amended so as to deliver outcomes closer to the mid-point, thereby undermining from now on the positive incentive to invest provided by the use of the 75th percentile WACC estimate in the current IMs.

#### ***Powerco comment***

- In our opinion, the Court has not undermined the incentives to invest provided by the current IMs, because:
  - There was no finding that the use of the 75th percentile WACC estimate was incorrect; rather the Court called on the Commission to examine this issue in its next review of the cost of capital IMs, in part since the Court otherwise needed to be satisfied that adopting a mid-point estimate (as MEUG proposed it should) would lead to 'materially better' cost of capital IMs;
  - it would, in any case, have been anticipated by the relevant parties that the 75th percentile element of the IMs (and other components of WACC) would be examined as part of a scheduled review of the other Part 4 IMs. The Court decision has not materially affected these expectations;
  - incentives to invest in long-lived assets are created by ensuring that businesses have confidence that there is a reasonable prospect of recovering their costs, including a fair risk adjusted return on invested capital; and
- We note that the Commission can remove any lingering doubt arising from the Court's decision by simply re-affirming its use of the 75th percentile WACC estimate until the next review of the cost of capital IMs.

### **4 Should the Commission bring forward a review of the cost of capital IMs?**

#### ***Commission position***

- Subsequent to the High Court judgment, submissions by consumer groups have asked the Commission to consider bringing forward the next review of the cost of capital IMs, which in any case must be completed no later than January 2018.
- For the review to be incorporated into the distributors' DPPs, or Transpower's IPP, the review would need to be completed by November 2014.
- The Commission has noted that the range of cost of capital issues that will need to be addressed in the next IMs review means that completing a full review by November 2014 is unlikely.

#### ***Powerco comment***

- For the reasons noted above, we concur that an appropriate review could not be adequately completed by November 2014, noting that the last review took over two years (and the AER's recent review took over 12 months).
- A rushed process that fails to properly consider all relevant issues would inflict considerable damage on the incentives to invest.

## 5 What evidence is there supporting either the 75th percentile or credible alternatives

### **Commission position**

- The Commission seeks submissions on evidence for either the 75th percentile or a credible alternative.

### **Powerco Comment**

- In our opinion the appropriateness or not of the 75th percentile WACC estimate is not a question that is separable from the issue of bias arising from various elements of the IMs.
- However, we note that the Commission, on several previous occasions (for example during the prior WACC consultation and, more recently, in the Orion CPP determination), has provided an explanation of why a 75th percentile estimate of WACC is considered appropriate. Reiteration and further expansion of these reasons by the Commission would assist stakeholders to gain a broader understanding of why the 75th percentile estimate does not over compensate regulated businesses.
- It follows from our response to Question 2 that we believe that issues identified in relation to why regulators adopting the CAPM framework systematically set a WACC above its mean (or average) estimate, are relevant and should be further considered by the Commission when a comprehensive review of the IMs is undertaken in 2017.

## 6 Impacts on the wider economy

### **Commission's position**

- The Commission seeks comments on whether the adoption of the 75th percentile has a material impact on the wider economy.

### **Powerco Comment**

Since we do not believe that adopting the 75th percentile WACC estimate necessarily means that regulated businesses are overcompensated, it follows that, if the cost of capital estimate is broadly correct and appropriately incentivises investment in essential infrastructure (which we believe to be the case), then there should be no impact on the wider economy, other than the avoidance of what would otherwise be a negative impact.

Finally, we believe that, given the time available to complete the DPP reset, the limited resources available to the Commission, the industry and other interested parties, and the absence of any evidence that the current WACC determination is fundamentally wrong and requires urgent review, the most efficient way forward would be for the Commission to implement the DPP reset according to the timetable already set and undertake a review of the Part 4 IMs in 2017 as part of the work programme previously planned.

Thank you for considering the points in this submission.

Yours sincerely



Richard Fletcher  
General Manager, Regulation and Government Affairs