

5 September 2019

**Sue Begg**  
**Deputy chair**  
**Commerce Commission**  
**PO Box 2351**  
**Wellington 6140**

**RE: Unsustainable WACC estimate for DPP3; bias and risk in CPI forecasts**

Dear Sue

It is unusual for me to write to you directly, but we have a specific issue which has become important. First, I would like to acknowledge that this letter is addressed to you as deputy chair but is also relevant to other Commissioners we engage with on electricity distribution regulation – Telecommunications Commissioner Dr Stephen Gale, Commissioner Elisabeth Welson, and, more recently, Associate Commissioner John Crawford.

Please accept that the letter is being sent out of the established regulatory cycle dealing with, in this instance, the substantial input methodology reset, next due in 2023. We understand where we are in the cycle, but, at seven years, it is a long window and there of course consequences that arise between resets.

I would also comment that while this letter is on an ENA letterhead, I am speaking on behalf of 14 of the 17 member companies which are on default or customised price paths. Three<sup>1</sup> of our members on DPP or CPPs are not supportive of this letter. Normally we prefer that all relevant members agree on positions, but sometimes this is not possible and we do occasionally present a qualified view. Nevertheless, the views expressed in this letter are that of a majority.

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<sup>1</sup> Powerco, Orion, Network Tasman

Normally ENA would request a meeting before sending a letter. Based on experience, I'm aware that Commissioners prefer not to engage while in deliberations on final decisions. We would of course, welcome a discussion at a mutually agreed time with you and your officials.

## **Purpose**

The purpose of this letter is to highlight non-exempt members' concerns about the Weighted Average Cost of Capital (WACC) for the forthcoming five-year regulatory period beginning April 2020. We are also concerned about the approach to forecasting inflation for the third default price path (DPP3).

Our realistic assessment is that we face:

- a WACC that is impractically low;
- bias in the CPI forecast revaluation component of returns; and
- far greater downside risks to CPI outturns than upside risks, given the deteriorating macro-economic environment.

If the current methodologies for setting the WACC and the exposure to CPI forecast error and bias remain, then our non-exempt members are confronting regulated returns so low that they risk being insufficient to meet investment responsibilities which service the needs of our customers. As custodians of critical infrastructure, this is clearly not a position we wish to be in.

## **WACC unrealistically low**

As I write, the three-month measurement period for the estimate of the risk-free rate used to finalise the WACC for electricity distribution businesses has finished.

In the ENA's recent cross-submission to the Commission on the DPP Draft Determination<sup>2</sup>, we registered on behalf of our members a significant concern that the unprecedented interest rate environment will flow through to a WACC that will be insufficient to motivate investment.

We drew specific attention to the problems of negative real Government bond rates, which are a proxy for the real risk-free rate. Since we made our submission, by the end of the measurement period nominal yields had fallen to new historic lows of only 0.8 percent, with an average of -0.9% in real terms (assuming inflation of two percent) over the measurement period.

Such an unprecedented environment of negative real interest rates was never contemplated when the WACC input methodology was reset in 2016.

In our submission ENA also noted that, in this unmatched low New Zealand interest rate environment, the Commission should not resile from its responsibility to make urgent changes to the WACC IM to ensure that the calculated WACC is sufficient to encourage investment.

One of the purposes of Part 4 of the Commerce Act is to promote the long-term benefit of consumers by promoting outcomes that are consistent with those in competitive markets "such that suppliers of

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<sup>2</sup> [Electricity Networks Association, 2020 DPP draft Decision submissions-cross submissions, p4.](#)

regulated goods or services have incentives to innovate and to invest, including in replacement, upgraded, and new assets”<sup>3</sup>.

We are seriously questioning whether lines companies will be adequately rewarded to innovate and invest when the nominal WACC is capped at 4.6 per cent and the inflation-adjusted WACC is only 2.6 per cent (assuming 2 per cent inflation, the RBNZ’s target).

ENA’s cross-submission referred the Commission to an expert report from Dr Tom Hird<sup>4</sup> on how these issues could be addressed. If it would assist the Commission, ENA would ask Dr Hird to be available to answer any questions on his report.

### **Bias to overestimate CPI forecast; and forecast errors**

In addition to our concerns about the calculation of WACC, at such low levels of WACC, forecast error in the CPI takes on substantially greater importance to EDBs.<sup>5</sup>

Because interest costs are nominal, CPI forecast error is concentrated on equity holders and represents a substantial part of the required return. There is a clear track record that the Reserve Bank of New Zealand has systematically over forecast CPI throughout the period of DPP regulation, and we have no confidence that this pattern will discontinue in DPP3.

In addition, there is little sign of inflationary pressures in the economy, so we assess that on top of forecast bias there is substantial downside risk to the RBNZ/Commission CPI forecast that inflation will trend back to two percent in 2021<sup>6</sup>. Realistically, even if the nominal WACC is set at 4.6%, EDBs would, on an expectations basis, earn less than 4.6% - given our concerns about CPI bias and downside risk assessments.

Accordingly, we reiterate our request that the Commission put in place mechanisms within the DPP to ‘true-up’ CPI forecast errors. This could be an annual, rather than five-yearly, wash-up mechanism.

### **Summary**

Enabling electricity distribution businesses to earn a fair market return will help ensure a correct level of investment in New Zealand distribution network. This is even more important for the DPP3 regulatory period with EDBs considering the change in investment required for parallel investment to support customer distributed energy resources, and government decarbonisation initiatives.

In summary, 14 non-exempt ENA members would much appreciate the Commission’s urgent attention on the important issues outlined in my letter.

I look forward to your response, and end with a request to meet to discuss our concerns at the earliest opportunity.

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<sup>3</sup> [Commerce Act 1986, 52A](#)

<sup>4</sup> [Competition Economists Group, Dealing with negative real risk-free rates, July 2019, p38](#)

<sup>5</sup> In DPP2, a CPI forecast of 2% made up 27.8% of ROI (2/7.19), given expected bond rates, CPI of 2% would now make up 43% of returns (2/4.6), and more than 50% of returns to equity.

<sup>6</sup> [Reserve Bank of New Zealand, Monetary Policy Statement, August 2019, p34](#)

**Regards**

A handwritten signature in black ink, appearing to be 'GP', with a long, sweeping diagonal line extending from the bottom right of the signature.

**Graeme Peters**  
**Chief Executive**  
**027 66 77 400**