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Dear Karen

Additional Information for Vector's cross-submission on the Input Methodologies Discussion Paper

Further to its original submission of 17 August 2009 and subsequent cross-submission of 28 August 2009 on the Input Methodologies Discussion Paper, Vector provides additional views below and encloses an updated "WACC Review" report from Synergies Economic Consulting ("SEC").

1. Synergies Economic Consulting WACC Review report

The Weighted Average Cost of Capital ("WACC") is a key element in providing a strong incentive to invest for the long term benefit of consumers. This incentive must be effective both in terms of maintaining investor confidence through sustaining returns on past investments and in absolute terms in respect of the attractiveness of new investments relative to the risk and to competing investment opportunities.

SEC's WACC Review report addresses a number of the inputs in the calculation of WACC. Key areas of the SEC WACC Review report on which Vector would like to comment are included in the discussion below.

1.1 Market Risk Premium

SEC propose an approach to estimating the Market Risk Premium (MRP) for use in the estimation of the cost of equity using the Capital Asset Pricing Model (CAPM) that produces a result that is materially higher than the 7% proposed by the Commission.

The Commission's approach has historically relied upon a range of approaches to estimating MRP and, recognising that all these approaches are imperfect, selecting the median from the range of outcomes. Having regard to the Commission's approach, of concern is that the Commission has proposed

retaining the 7% estimate that it has used in the past. Vector believes that there are strong indicators that this estimate is understated, including:

- The alternative estimation approach proposed by SEC;
- The adoption of a higher MRP in the recent decision by the Australian Energy Regulator;
- Updated estimates of the ex ante approach to estimating MRP - Vector notes that this estimate was as high as 8.8% at the height of the Global Financial Crisis in October 2008 and currently sits at 7.1% (materially higher than the values of 6.0% and 5.4% used by the Commission)¹; and
- In the context of the Global Financial Crisis the survey result based estimates of MRP may also be understated.

1.2 Beta

SEC have undertaken:

- a first principles assessment of beta for Vector as a firm operating in the electricity lines and gas pipelines businesses;
- a comparative companies analysis; and
- an examination of rolling betas for the most relevant firms.

Based on the comparator analysis, SEC finds that they cannot conclude that an alternative estimate is materially better than Lally's 0.30 for US electric utilities. SEC also concur with the 0.20 adjustment to reflect the differences between US rate of return regulation and a five year price cap regime and a further 0.10 adjustment to reflect differences in the systematic risk of gas versus electricity.

Vector notes that the Default Price Path ("DPP") is clearly a five year price cap regime, with material consequences for breaches. It is not expected that a full building blocks approach will be used to set the DPP. Firms have the option of applying for a Customised Price Path ("CPP"). CPP is expected to be a full building blocks approach. In the context of estimating beta, Vector sees little virtue in the CPP option as:

- The extent to which firms may rely on the DPP approach, rather than the CPP approach is, to a large extent, subject to the discretion of the Commission in terms of its approach to setting the DPP in the first place;
- The CPP, if used, will be a full building blocks approach with all the associated rigour evident in UK style price cap regulation, producing an outcome for the firm that is no better than if a full building blocks price cap approach had been applied in the first instance;
- The CPP option is rationed, ie the Commission is only required to process four applications per sector per year;
- The CPP option is costly and brings the risk of an outcome worse than that provided by the DPP.

2. Other Comments

SEC have not commented specifically on the estimate of the debt margin or Debt Risk Premium ("DRP"), debt issuance costs or equity issuance costs. Vector's views on these matters are expressed below.

¹ Lally 2005; "The Weighted Average Cost of Capital for Electricity Lines Businesses" and Lally 2008; "The Weighted Average Cost of Capital for Gas Pipeline Businesses";

Vector believes that prudent management of the real-world interest rate and liquidity risks faced by businesses means that, as acknowledged by the Commission, debt is likely to be raised over a range of maturities. Further, due to lenders' appetite for risk and exposure to particular firms and/or industries there may be a need to access a range of debt markets (both domestic and offshore). The legitimate costs of this risk management should be reflected in the overall regulatory cost of debt through an adjustment to the DRP.

It is also prudent for firms to maintain debt facilities over and above its drawn debt lines. This cost should also be included in the overall regulatory cost of debt through an adjustment to the DRP.

In Vector's view, debt issuance costs are real costs that, given the Commission's proposed approach to estimating the DRP, are excluded from the overall regulatory cost of debt. While Vector is broadly comfortable with the Commission's estimate of 0.30% per annum for debt issuance costs, it is Vector's strong belief that this cost needs to be reflected in the WACC. Vector does not support these costs being reflected through the cash flows (an alternative posited by the Commission) because it is not clear how these costs would be accounted for in practice in setting the DPP or assessing current or future profitability. It is much simpler for the benchmark WACC to include an allowance for these costs.

Similarly, Vector feels that it is erroneous to presume that equity capital is drawn from retained earnings. Vector believes that costs of raising equity are real costs that have been faced by extant firms in the past and are costs that would be faced by an efficient new entrant if the competitive benchmark were considered. Vector estimates that the direct costs of raising equity, if amortised, would be in the order of 0.35% per annum. Recent experience in the market shows that there is also a potentially significant indirect cost of raising equity when issue price is discounted to the market price.

Yours sincerely



Allan Carvell

Group General Manager Regulation and Pricing

Attached: WACC Review: Final; Synergies Economic Consulting; 31 August 2009