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Mr P Goodeve
Regulation, Pricing & Risk Manager
Powerco Limited
84 Liardet Street
Private Bag 2061
New Plymouth 4310

Dear Mr Goodeve

Re: Commerce Commission's Revised Draft Guidelines and aspects of the Input Methodologies Discussion Paper addressing the Cost of Capital

We are pleased to present our report on the Commerce Commission's (the Commission) Revised Draft Guidelines (Guidelines) and aspects of the Input Methodologies Discussion Paper that relate to the estimation of the cost of capital.

While we have commented upon a number of matters raised in these documents, our key comments can be summarised as follows:

- **Term of the risk free rate in the CAPM** – We agree with the Commission that the same risk free rate should be used in the two places that it enters the CAPM. We note that this consistency means that using a term for the risk free rate that differs to the length of the regulatory period cannot systematically lead to a regulated business being under or over-compensated (at least if its beta is close to 1). Given that theory is indeterminate on the appropriate term for the risk free rate, and standard commercial practice is to apply a long term bond rate in the CAPM, we recommend that the Commission adopts a 10 year term.

- **Market risk premium** – The Global Financial Crisis has highlighted market risks that had not been considered when the Commission first applied a 7 percent Tax Adjusted Market Risk Premium (TAMRP). We agree with two members of the Panel, professors Franks and Myers, that market risk either has increased or has again been appreciated as a result of the crisis, and we also agree with these professors that most weight should be accorded to long term historical data. We note that as well as referencing out-of-date information, Associate Professor Lally's estimate of a 7 percent TAMRP is influenced materially by estimates of the premium that employ unreliable estimation techniques. By referencing the most recent long term historical data for the 8 largest equity markets in the world, a TAMRP of 8.6 percent is indicated, while referencing the recent decision of the Australian Energy Regulator (AER), a TAMRP of 7.5 percent is implied for New Zealand. Therefore, we recommend the Commission raises the regulatory TAMRP to at least 7.5 percent.

- **Beta** – With respect to electricity, given the absence of sufficient domestic comparators, the approach formerly applied by the Commission, which looked at US electricity betas and adjusted for differences in the regulatory regime, is a reasonable and pragmatic approach in the circumstances. Econometric analysis of divisional betas based on evidence for multi-divisional gas and electricity firms should be treated with caution. We note that if the Commission was to use a non-zero debt beta (which, however, would be out of step with most regulators and market practitioners) then the Commission would need to revise upwards the asset betas that it has previously observed and applied to be consistent with that debt beta.

- **Cost of debt** – The Commission's methodology for estimating a benchmark cost of debt should be based on a clearly identified methodology that is founded on observation of market practice. This evidence would need to reflect observed gearing levels, associated credit ratings and observed debt margins that are consistent with these benchmark assumptions. Market evidence must also be relied upon in determining the term of debt assumption. Such an analysis has recently been undertaken by the AER, which concluded that there was no persuasive evidence to shift from a previous assumption of a 10 year term. We believe that the Commission would be drawn to a similar conclusion if it adopts a methodology that relies on observed practice.

Should you wish to discuss this report, please do not hesitate to contact Jeff on + 61 412 388 372.

Yours sincerely,

JJ Balchin

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