Cost of equity

APGA Presentation

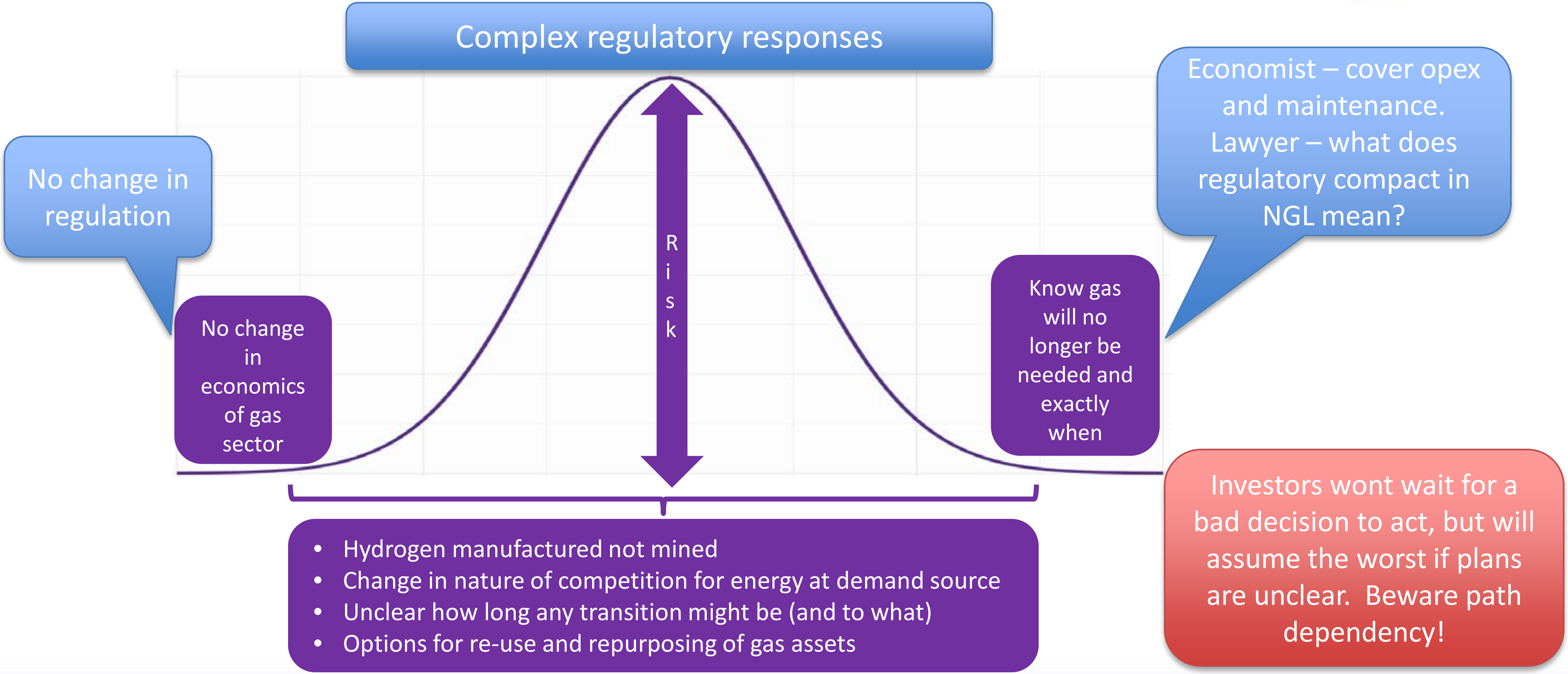
11 Aug 2021

Overview

Parameter	View
MRP	✓ ENA
Beta	✓ ENA (but consider if enough information for gas)
Avg period	✓ ENA
Cross checks	See last week

- Thinking about risk for gas sector
  - Range of gas futures and regulatory responses
  - Consider need for action
  - Consider and assess tools
  - Consider other regulators
  - APGA view

Range of gas futures



Is there a need for action?

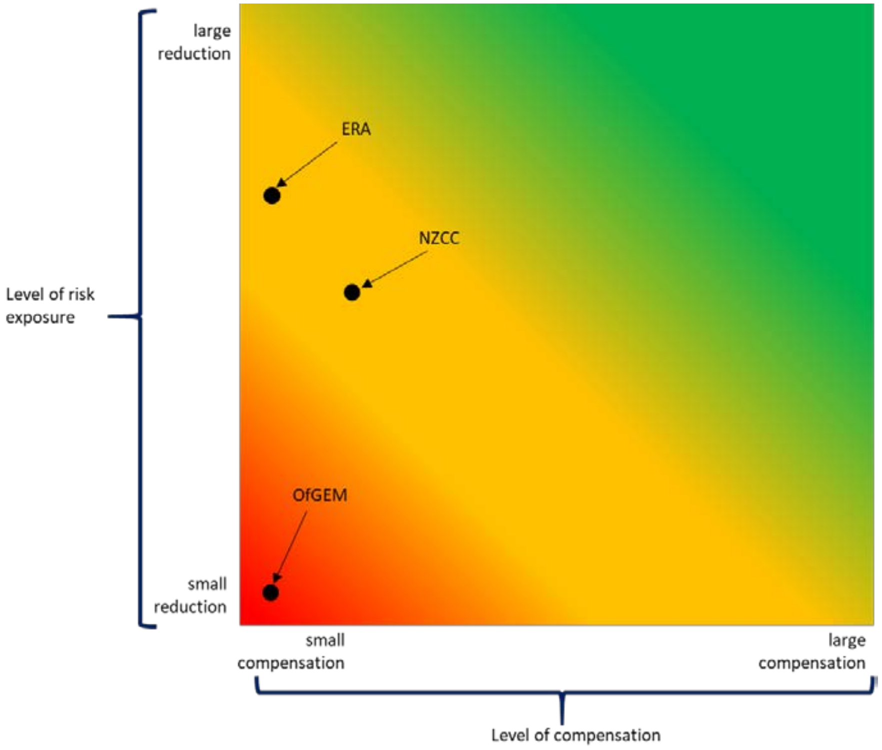
- In theory, if risks changed market would reprice everything automatically, AER need do nothing, but:
  - Markets are imperfect and do not price all risks perfectly, particularly as they change
  - AER can't pull perfect information from the market
    - Use of historical data, small sample sizes, imperfect models, imprecise results, mix of gas and electricity information, etc, etc
  - AER only pulls information from the market sporadically
    - RoRI once every 4 years, AA once every 5
    - Future of gas is moving *much* more quickly than this

In practice, the AER needs to think about changing risk profiles, and cannot simply rely on perfect markets to solve all problems

Stranding and WACC

- Should asset stranding be dealt with in WACC?
  - Some aspects associated with asset stranding may be systematic
    - Decarbonisation is as global as interest rates and industry exposure differs
  - If regulation reduces risk, and gas is headed for competition, higher WACC makes sense
  - Risks are complex and costs of errors may be high
    - Direction of desired investment signal is unclear
    - Path dependency is a problem – railways example
  - Lowest cost solution for consumers will require many tools
- Answer should be driven by pragmatic consideration of long term interests of consumers, not arcane economic theory

Tools and their use



- Change the risk via tools like accelerated depreciation
- Compensate for risk via tools like WACC
- But:
  - future uncertain so you never know how much to accelerate, so;
  - some risk always remains on table
- So tools work together
  - Pragmatic balance of most efficient combination given information set
  - Too much reliance on one tool may *increase* cost to consumers

Other regulators

- NZCC
  - Allowing changes in asset lives – “economic asset stranding”
  - Principle of *expected* financial capital maintenance
    - Firms should expect to get invested capital back
  - Allowance to account for uncertainty of expectations
- ERA
  - Accepted depreciation acceleration on basis of small price change, no change in WACC (asked for or given)
    - Solution not perfect but kudos for not simply kicking can down the road
- OfGEM – laggard, but cases before CMA may force action
  - Businesses have asked for depreciation and WACC solutions

APGA preference

- Recognise that something needs to be done
  - Risk of gas businesses different to electricity
  - 2022 RORI should be developed with stranding asset risk approach in mind (no more siloes)
- No double-counting, but best available response for each business
  - Accelerated depreciation and WACC can play a role, which may differ business to business and through time as information evolves
    - Accelerated depreciation captures *expected* change in asset lives and WACC the *confidence in* that change -NZCC
- Consider price impacts of options (eg – ERA)
- Support development of robust methodology
  - Investors need to be understand how AER will assess risks and act next year
  - We need to plan over 30 years, not four and not five