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wellington electricity

Wellington Electricity
Lines Limited

75 The Esplanade
Petone, PO Box 31049
Lower Hutt 5040
New Zealand

Tel: +64 4 915 6100
Fax: +64 4 915 6130
www.welectricity.co.nz

Keston Ruxton
Manager, Input Methodologies Review
Commerce Commission

By email: im.review@comcom.govt.nz

Dear Keston Ruxton

INPUT METHODOLOGIES REVIEW: RESPONSE TO TECHNICAL CONSULTATION UPDATE PAPER

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to respond to the Commerce Commission's (**Commission**) technical consultation update paper. WELL supports the submission being made by the ENA on this update paper.

The Commission's technical consultation update paper proposes several substantive changes to its draft decision. The update paper also sets out the Commission's position following further consultation, including a workshop, on the cost of capital.

1. Summary of submission

As detailed below, WELL is concerned that several of the changes set out in the Commission's technical update paper are not supported by clearly articulated reasons and/or have appeared for the first time in the technical consultation paper. This restricts the ability of stakeholders to engage with the Commission's process, and as a result may undermine regulatory certainty and investor confidence.

Specifically, our submission in response to the Commission's paper sets out the following:

- a full trailing average approach to estimating the cost of debt over a 10 year period is the optimal approach for both consumers and businesses. The next best alternative is the proposed historic average approach for the debt risk premium (**DRP**). Both options are preferable to the draft decision's 'rate on the day' approach although further consultation is sought on the historic average approach;
- debt issuance costs should be included within the WACC and not determined as part of operating expenditure;
- treating debt issuance costs as operating expenditure creates a difference between regulatory accounting and generally accepted accounting practice, which adds complexity and risk that is not necessary;
- there is no material uncertainty regarding the quantum of an appropriate allowance for debt issuance costs;
- the proposed distinction between wholly owned (100%) Government entities and majority owned (>50%) Government entities for inclusion in the comparator set used to evaluate the debt risk premium is flawed. WELL considers there to be little, if any, difference in the credit risk profiles between these two Government ownership models;
- the Commission should give due consideration to an allowance for equity raising costs or explain why no compensation will be provided;
- the Commission should address the inflation risk in the current framework in the manner suggested in this submission;
- the input methodology should not set the level of any cap on the wash-up amount, or make this feature mandatory in a DPP or CPP determination;

- we support the removal of the cap and collar on the draw down amount, as it introduces unnecessary complexity;
- the mandatory draw down on the wash-up account where a balance is in favour of customers introduces unnecessary complexity and can be more simply addressed by applying a time value of money adjustment;
- the input methodology should not set out the Commission's proposed criteria for assessing quality standard variation reopeners, as the relevant test is the extent to which any application is consistent with the objectives of Part 4 of the Commerce Act;
- the Commission recognises the current issues raised in regards to health and safety around live line work when finalising the quality standards variation reopener provisions; and
- the transition timeframe for the introduction of the revised cost allocation methodology (which WELL does not support the revised methodology) is too tight and for practical reasons should the revised methodology proceed, be extended by 12 months.

2. Cost of capital

The Commission has outlined two possible positions and one significant change for setting the weighted average cost of capital (**WACC**) in its technical update paper. Specifically, the Commission has proposed the following:

- the retention of the status quo rate on the day approach (with an extension of the pricing window from one month to three months), or, the historic average for the DRP plus the rate on the day approach for the risk free rate (referred to as the 'hybrid historic average' approach); and
- removal of debt issuance costs from the WACC determination, and instead, allowing electricity distribution businesses (**EDBs**) to recover these as an operating expenditure allowance.

This section responds to the technical implementation of the above, as well as the need for equity raising costs and the removal of inflation risk. Whilst the Commission has requested comments to focus on the technical implementation, as it is the first time we are being asked to comment on the hybrid historic average approach, we have also included our initial evaluation of its relative merits.

Hybrid historic average cost of debt approach

In its technical update paper, the Commission discusses an historic average cost of debt approach, which WELL considers a 'hybrid' of the rate on the day and WELL's preferred methodology of a full 10 year trailing average approach. Although it is not reflected in the draft input methodologies, the Commission is considering this hybrid approach for its final decision.

Under the hybrid historic average approach, only the risk free rate component is determined using the 'on the day' approach and the DRP component is determined using a trailing average over a five year period. WELL considers this approach, on the face of it, to be superior and more practical than the existing 'on the day' approach (currently included in the draft input methodologies). This approach recognises that debt margins cannot be hedged by EDB's. It also mirrors the existing debt management practices, particularly of larger EDBs.

However, WELL considers that the proposed implementation of this hybrid historic average approach needs further evaluation for the reasons discussed below.

Whilst the hybrid historic average approach appears to be an improvement, it may inadvertently create other risk. Notably, the actual debt financing practices of EDBs include hedging to swap rates, rather than the prevailing risk free rate. A further refinement to the hybrid approach would be to allow for a prevailing swap rate (instead of risk free rate) and a trailing average debt margin over the swap rate.

It is also not clear, however, why the Commission proposed a five year tenor for averaging the DRP, nor how the averaging will work in practice. It appears from the update paper that the Commission intends to 'lock in an historic average for each 5 year DPP period (based on the previous 5 years) rather than update annually over the 5 year period (consistent with a trailing average). If the former, this needs further evaluation to determine whether this is actually an improvement when compared to the 'rate on the day' approach.

The misalignment risk and uncertainty with the hybrid historic average methodology is another reason why WELL continues to recommend that a full trailing average approach be applied as noted below.

WELL notes that one benefit of the hybrid historic averaging methodology for the DRP, is that it can be more easily transitioned to a full trailing average (WELL's preferred approach, as noted below) in future input methodology reviews (i.e. for both the DRP and risk free rate component). Since the DRP is measured in a similar manner to the trailing average approach, it is only the risk free rate component that would need to be transitioned. In their report for Australian Gas Networks, CEG proposed a transition from a similar hybrid approach to the full trailing average approach.[1] Such a transition to a full trailing average would remove any possibility of windfall gains or losses. It will also assist the Commission to progress towards a better methodology, which is consistent with efficient debt financing practices.

Given the above, WELL considers the Commission should consult further with EDBs on this proposal to ensure it is consistent with EDBs actual debt financing practice.

For the reasons outlined below, WELL continues to support a 10 year averaging period. Using the data collected from EDBs, the weighted average tenor of bonds issued by firms is 10.4 years, while the average tenor is 9.3 years. The Commission's own consultant, Dr Lally, advocated the use of a seven year averaging period based on 2010 debt data. A period longer than five years would also avoid the need for a term credit spread differential adjustment.

<u>Averaging period for the on the day cost of debt approach</u>

As outlined in previous submissions, the on the day approach does not reflect the costs of an efficient and viable debt management strategy. In particular, every time a regulatory decision is made both consumers and EDBs are subject to the volatilities of market interest rates (i.e. what one might call a roll of the dice).

In his review of further WACC issues, Dr Lally advised the Commission to widen the averaging period from one month to three months. The Commission considered this as part of the revised draft input methodologies. A three month averaging period, however, is neither efficient nor practical. For example, it would require EDB's to hedge continuously over three months (i.e. to hedge against the regulatory benchmark). This will result in hedging very small amounts, which will incur higher hedging costs (that should be reflected in the debt issuance allowance, discussed below). Alternatively, EDB's will be forced to hedge over an interim period within the three month window, making it impossible to achieve a cost of debt that aligns with the regulated cost of debt allowance.

A three month averaging period is also unlikely to properly mitigate the New Zealand market issue of limited supply when multiple parties are required to transact in the same narrow pricing window. Instead, to the extent the Commission's preference is to have the same cost of debt estimate for all large EDB's—requiring, therefore, the same market pricing period—this is best achieved through adopting a trailing average approach. If the Commission adopts a 10 year trailing average approach, EDB's would be required to raise only small amounts of debt each year, avoiding the market liquidity (and pricing distortion) problem noted above.

For completeness, WELL notes that the proposed technical implementation outlined in the draft input methodologies would achieve what the Commission is considering for this approach.

<u>Full trailing average cost of debt – the optimal approach</u>

For the avoidance of doubt and for reasons outlined in previous submissions and at the Commission's WACC workshop in September, we continue to recommend the Commission adopt a 10 year trailing average approach for estimating the cost of debt.[2] This approach is consistent with the financing practices of large EDBs and Transpower (i.e. significant amounts of debt are refinanced on an annual basis, and over extended periods of time), and promotes an outcome that is consistent with the intent of the Commerce Act to enable workably competitive outcomes.

At the Commission's WACC workshop, there appeared to be a consistent view that a trailing average approach is superior compared with rate on the day alternatives. This was reinforced by the recent analysis undertaken by

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1 CEG, *The hybrid method for the transition to the trailing average rate of return on debt: assessment and calculations for AGN*, June 2015.

2 See, for example: WELL, *Input methodologies review: response to draft decisions*, 4 August 2016.

Frontier Economics on behalf of Transpower.[3] In this analysis, Frontier clearly showed how a trailing average best fulfils the 'NPV=0' principle.

There appears to be less agreement, however, on the optimal time period for a trailing average approach. WELL considers the adoption of 10 year averaging period better smooths out short term market volatility in prices to consumers, and better reflects the average tenor of efficient financing practices for long lived assets.

To highlight the benefits of a 10 year period, it is conceivable that interest rates will rise before the next DPP reset. A five year averaging approach would mean that consumers 'miss out' on the full trailing benefit of the current extended low interest rate period. To the extent the Commission aims to balance long term benefits and short term prices, greater price stability through a 10 year averaging period arguably achieves both.

The input methodology review provides a clear opportunity to revisit the Commission's current approach and ensure that EDB's are adequately financed and resilient to adverse market conditions. The Commission's approach should be encouraging of EDB's utilising a balanced portfolio approach to debt maturities, by raising long term debt that is more aligned with long lives of assets, as well as reducing the risk of refinancing.

Debt issuance costs

The Commission's technical update paper proposed, without prior consultation, to change the recovery of debt issuance costs to operating expenditure. The technical update paper does not explain the methodology for estimating these costs (i.e. operating expenditure allowances are currently determined using an average over a specified historic period and the Commission has not acknowledged if it will continue to use this approach). Accordingly, WELL has been unable to assess whether this change will be cash flow neutral.

The rationale for the Commission's approach appears to be that it has a degree of uncertainty over what the efficient level of debt issuance costs should be.[4] The Commission, however, has received evidence of actual debt issuance costs from EDB's and so the degree of uncertainty should only be low. It is unclear, therefore, why the Commission is not in a strong position to estimate an appropriate allowance for debt issuance costs.

The Commission also cited evidence of the issuance costs for Contact Energy. As Contact Energy is a large publicly listed gentailer, it is not a valid comparator for a benchmark efficient regulated electricity distribution or transmission business. As noted at the WACC workshop, there remains doubt as to whether Contact's assessment of its own debt issuance costs is in fact a like-for-like comparison with debt issuance costs incurred by EDB's and Transpower.

WELL also has a practical concern around the proposed change to the draft input methodologies for debt issuance costs. Under generally accepted accounting practice (**GAAP**) these costs are accounted for as financing expenditure. If for regulatory purposes EDB's are required to treat them as operating expenditure, this will create another difference between regulatory accounting and GAAP. This increases the risks of errors in IDR's by introducing a manual process to reclassify expenditure.

The proposed change to the draft input methodologies for the debt premium estimation also means that majority Government owned entities will be included in the comparator set. WELL considers there is little distinction in terms of the risk profile between wholly owned (100 per cent) and majority owned (greater than 50 per cent) Government entities. Majority owned Government entities should be treated the same as wholly owned Government entities for the purposes of benchmarking debt issuance costs.

Given the above, we recommend the Commission continues with the approach adopted in its draft decision and include debt issuance costs as part of the cost of capital (instead of operating expenditure). The allowance for these costs should be set based on the evidence provided by EDB's and independent debt market lenders such as banks. As discussed at the WACC workshop, this evidence supports retaining the current allowance of 35 basis points, which is greater than the 20 basis points proposed by the Commission.

As noted above, if the Commission continues with its rate on the day approach included in the draft decision, the allowance for debt issuance costs should reflect the increased hedging costs that arise with the use of a longer

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3 Frontier Economics, *Response to cost of capital issues raised in draft input methodologies*, August 2016.

4 See, for example, paragraph 76 of the Commission's technical update paper.

averaging period. Depending on the actual period used, EDBs will be required to enter into forward start swap arrangements over a longer period, increasing the cost.

Equity raising costs

The technical consultation paper does not include any allowance for equity raising costs, but this issue is pertinent to the above discussion on debt issuance costs. From time to time new equity is needed to maintain a given capital structure and credit rating. Equity raisings are especially required when capital expenditure grows faster than revenues. These are efficient costs, and like debt issuance costs that the businesses incur, should be compensated for.

The AER explicitly compensates EDB's for equity raising costs in their post-tax revenue model. For example, in its October 2015 draft decision for Victorian businesses, the AER stated the following:[5]

> *Equity raising costs are an unavoidable aspect of raising equity that would be incurred by a prudent service provider acting efficiently. Accordingly, we provide an allowance to recover an efficient amount of equity raising costs.*

We recommend the Commission provides compensation for equity raising costs. This could be achieved either by increasing the debt issuance costs to reflect these, or making an allowance similar to AER's methodology for estimating equity raising costs.

Inflation

The Commission sets forecast inflation based on the forecast and target inflation rate from the underlying Monetary Policy Statement of the Reserve Bank of New Zealand (**RBNZ**). There is no analysis performed to confirm that this forecast has performed as an unbiased estimate of actual inflation historically. In fact, the RBNZ forecast and target inflation rate is so diverged from the actual inflation that it could result in significant losses to EDBs. This is an unnecessary regulatory risk for both EDB's and consumers.

Under the current economic environment, where the inflation is persistently lower than the forecast inflation, the mismatch in treatment of inflation between DPP and information disclosure requirements has significant impacts on EDBs' ability to recover their efficient costs. When issuing debt EDBs' enter into contracts that require nominal interest payments. The potential for forecasting error on inflation compromises the ability of businesses to meet their nominal interest payment obligations. As noted above, for EDBs to match the regulated cost of debt allowance they are required to hedge in the same averaging window. Hedging locks in the nominal interest payments and therefore the inflation risk faced by EDBs.

We consider that an assumption that errors will offset over time should not be a basis for failing to address this risk. We propose that Commission updates the inflation forecast in the DPP model by actual inflation each year when it updates the cost of debt annually under trailing average or hybrid historic average method. Once the allowances are updated to reflect the actual inflation, both EDB's and consumers will not be exposed to the regulatory inflation risk as a result of forecasting error and a mismatch between the DPP and information disclosure requirements.

3. Implementation of a revenue cap

WELL continues to support the introduction of a revenue cap, but has concerns with some of the changes set out in the Commission's technical update paper.

Revenue wash-up cap

The Commission's draft decision proposed that annual revenue allowances be calculated with reference to a 'wash-up' account. The draft decision also stated that any decision regarding implementation—for example, the level of any cap on the wash-up amount and whether it would be mandatorily applied—would be made at the time of a default price-quality path (**DPP**) or customised price-quality path (**CPP**) determination.

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5 AER, *Final decision, CitiPower distribution determination 2016 to 2020, Attachment 3 – Rate of return*, May 2016, p. 3–365.

In its technical update paper, the Commission now proposes to set the revenue wash-up cap as part of its input methodology final decision. The proposed cap is 20 per cent of the forecast maximum allowable revenue in the first year of the relevant regulatory period. The Commission also proposes to apply the cap as a mandatory feature of all DPP or CPP determinations.

WELL has previously submitted to the Commission reasons why EDBs should be able to recover the expenditure required to prudently and efficiently operate and maintain the network (including that required following a catastrophic event).[6] WELL expected to continue to engage on this issue with the Commission at the time future DPP or CPP applications are determined.

WELL is concerned, therefore, at the Commission's process for proposing such substantive changes to its input methodology draft decision as part of its technical update paper. The Commission has provided no evidence to support the level of its proposed cap (indeed, it acknowledges it is subjective), and instead, simply cited improved regulatory certainty as the basis for its decision.

While regulatory certainty is important, it should not be at the expense of due process or the importance of clearly articulating why the decision best meets the long term benefits of consumers (as set out in Part 4 of the Commerce Act). Providing clear reasoning promotes regulatory certainty and investor confidence. On this basis, the input methodology should not set the level of any cap on the wash-up amount, or make this feature mandatory in a DPP or CPP determination.

Cap and collar on draw downs

In its technical update paper, the Commission states it will now remove the cap and collar on the draw down amount. WELL supports this change, as consistent with our previous submissions, the cap and collar on the draw down amount introduced unnecessary complexity.[7]

Mandatory draw down in favour of customers

The Commission proposes that where a balance in the wash-up account is in favour of customers, this balance must be returned to customers as soon as possible. This approach introduces unnecessary complexity to the implementation of a revenue cap.

Instead, any concern regarding EDBs incentives to delay returning an over-recovery to consumers can be appropriately dealt with by applying the time value of money (i.e. applying the time value of money to the wash-up balance will ensure customers are compensated for any over-recovery). This approach is applied by regulators in other jurisdictions where revenue caps apply, such as the UK and Australia, and avoids the need to introduce complex draw down requirements.

4. Criteria for assessing quality standard variation reopeners

WELL does not support the inclusion in the input methodology of the Commission's proposed criteria for assessing quality standard variation reopeners. These criteria have regard to stakeholder engagement and customer support, but do not consider other relevant factors such as economic efficiency or the previously identified impacts from changes to health and safety legislation for live line work. WELL considers the current change event reopener could be a workable option for the impact of the new health and safety legislation provided the materiality threshold is suitable. In any event, WELL considers the relevant test is the extent to which any reopener application is consistent with the objectives of Part 4 of the Commerce Act.

Further, the Commission has not included assessment criteria for other DPP reopeners in its input methodology.

As noted above, we are also concerned at the Commission's process for making such a decision. The technical update paper provides no reason for the basis of these criteria. A more preferable alternative would be to set out any relevant criteria in a separate guideline (following an appropriate consultation process).

6 See, for example: WELL, *Input methodologies review: response to draft decisions*, 4 August 2016, pp. 2–3.

7 See, for example: WELL, *Input methodologies review: response to draft decisions*, 4 August 2016, p. 2.

5. Timeframe for transitioning to new cost allocation methodology

The proposed timeframe for the removal of avoidable cost allocation methodology (**ACAM**), should that proceed, is not sufficient to implement the anticipated system and process change requirements. For example, WELL would need to develop systems for staff to allocate time to each of these services. It is also appropriate that sufficient time be given for EDBs to re-evaluate the business case for working with and supporting other utilities, for example through the use of shared pole assets. The administrative burden required to complete the annual information disclosure requirements will also increase. The initial change and subsequent additional work requirements will increase costs associated with the provision of electricity distribution services and therefore increase costs to consumers.

The Commission has also recognised the need to compensate EDBs for the costs of changing accounting systems should ACAM be removed. To allow adequate time for the above changes, and to determine how EDBs will be compensated for the costs of these changes, WELL considers the effective date for any such change should be extended by 12 months to 1 April 2019.

For the avoidance of doubt WELL does not consider the removal of ACAM is an appropriate solution to the issues raised by some submitters and its retention with a lower threshold is a more balanced and reasonable solution.

6. Conclusion

For the reasons stated above, WELL recommends the Commission only make changes from its draft decision where it has undertaken a thorough consultation process. This is consistent with the purpose of the technical consultation update paper, to ensure the revised draft input methodologies reflect the Commission's stated policy intent. As noted above WELL considers there are several areas where the Commission still has the opportunity to ensure the revised IM's deliver an optimal outcome for consumers and EDB's.

If the Commission has any queries regarding WELL's submission, please do not hesitate to contact Jeff Anderson, Regulatory Projects Manager, at janderson@welectricity.co.nz.

Yours sincerely

Greg Skelton

CHIEF EXECUTIVE OFFICER