

17 October 2019

Graeme Peters
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Electricity Networks Association
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Wellington 6011

Dear Graeme

WACC estimate for DPP3 and CPI forecasts

1. Thank you for your letter dated 5 September 2019, in which you relay the concerns of some of your non-exempt members in relation to weighted average cost of capital (**WACC**) estimates for the third default price-quality path (**DPP3**), and perceived biases and risks associated with Consumers Price Index (**CPI**) forecasts. In particular, those 14 members consider that they face:
 - a WACC that is unrealistically low;
 - bias in the CPI forecast revaluation component of returns; and
 - far greater downside risks to CPI outturns than upside risks.
2. As you have noted in your letter, we are currently considering submissions on our DPP3 draft decision. Our final determination for DPP3 must be made before the end of November 2019. In certain of the submissions on our draft DPP3 decision, EDBs raised similar concerns to those in your letter regarding the application of the WACC methodology in the present economic climate.
3. Your letter does not expressly state the particular outcome sought by you and the 14 members. However, because the WACC and the treatment of CPI forecasts are matters dealt with in the input methodologies (**IMs**), it appears that you are requesting the Commission to undertake an urgent reconsideration of the WACC IM so that it could be amended, and a new WACC determined, before DPP3 is determined at the end of next month.
4. We have given the particular matters raised in your letter serious consideration. However, for the reasons explained in this letter, we do not consider that an urgent reconsideration of the WACC IM is warranted in the circumstances.
5. Given the wide stakeholder interest in these topics, we intend to publish your letter and this response on the DPP3 project page of our website.

The regulatory cycles are designed to provide certainty for market participants

6. Under section 52R of the Commerce Act 1986 (**Act**), the purpose of the IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to regulation under Part 4, including the price-quality paths for electricity lines services. Section 52T(2) obliges the Commission to ensure that the IMs, as far as is reasonably practicable, are expressed in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier.
7. The certainty that results from the IMs enables businesses to be clear on the future regulatory framework and to employ the necessary strategies to mitigate the effects of prevailing external market conditions; for example, when putting in place financing arrangements.
8. The fact that, in accordance with section 53M(4), the DPP regulatory period runs for 5 years and “locks in” a price/revenue path for that period, and that, under section 53ZB, a DPP determination cannot be re-opened to take account of subsequent amendments to IMs, also provides certainty for stakeholders.
9. Of course, certainty is not an absolute virtue. Flexibility is also provided through various mechanisms, including:
 - X factor adjustments: under section 53P(8), we have the ability to consider circumstances of financial hardship for individual electricity distribution businesses (**EDBs**) in setting their X factors for the DPP.
 - DPP re-openers: the EDB IMs provide for a limited number of re-opener events for the DPP (e.g. upon the occurrence of catastrophic events, changes in legislative or regulatory requirements, errors or major transactions).
 - Customised price-quality paths (**CPPs**): the DPP relies on a relatively low-cost approach for setting price or revenue limits and minimum standards for quality of service. If an EDB believes the DPP does not meet its needs, particularly in terms of future investment requirements, it can apply for a CPP. A customised path is tailored to the company's specific plans and requires us to complete a detailed assessment of its proposal before making a decision on what its price path and quality standards should be.
10. The IMs can also be amended. This provides the potential for further flexibility. Current examples include the proposed IM amendments in relation to operating leases, which attempt to address recent changes to GAAP.
11. However, we consider that there is a significant hurdle of persuasion to overcome before the Commission would embark on a full review of the WACC IM at this time, outside the IM review cycle. Given the IMs’ foundational status for Part 4 regulation, and their statutory purpose of promoting certainty, it would be essential that adequate time is allowed for consultation in consideration of any amendments. Amending the IMs without sufficient and transparent consultation is likely to create significant uncertainty for the regulatory regime, and may result in detrimental effects for consumers and businesses. The matters you raise in your letter are all contestable, and to attempt to review the WACC IM and redetermine the WACC before the end of November would likely give other stakeholders significant cause for complaint.

12. Such a review of the WACC IM would be undertaken in circumstances of extreme urgency, and would also occur in circumstances where EDBs had had the opportunity to raise these issues at an earlier point.
13. We do not rule out this possibility in principle, but consider that, for the reasons discussed below, the current circumstances fall well short of meeting this threshold.

Opportunity for EDB input on these matters

14. As you and your members will be aware, the principles and methodology for calculating the WACC and other issues were extensively consulted on as part of the IM review process in 2016. Interested parties also had the ability to seek a merits appeal of our final decision at that time.
15. At the time of the IM review, there was evidence to suggest that the current market conditions could exist. The present environment may have been difficult to forecast with precision, but, in our view, it was certainly a clear possibility at the end of 2016:
 - The five year risk-free rate in the Commission's September 2016 WACC Determination for EDBs was 1.85%¹, having been on an almost continuous decline since September 2013, when it was 3.95%²;
 - Noting that the risk-free rate in the WACC IM is based on the yield for 5 year New Zealand government bonds, there were no fewer than 14 foreign governments with *negative-yielding* debt by early June 2016³.
16. In other words, we do not accept your view that the current economic environment was beyond contemplation when the WACC IMs were reviewed in 2016.
17. Even if the developments cited above were too novel in 2016 to have been able to have been the subject of submissions during the IM review, there have been several years since then for EDBs to assemble the evidence if there was a compelling case for amending the WACC IM. Having considered your letter and the submissions provided in response to the DPP draft decision, in our view these do not amount to a sufficient basis for initiating an IM amendment process now.

The claim that the WACC rate is now unrealistically low

18. We appreciate the concerns that your members have around changing external economic factors and the impact that those factors are having on the prevailing WACC rates for DPP3. Alternatives to the current WACC methodology, such as a 10 year trailing average, were considered as part of the IM review process in 2016.
19. As we noted in the IM Review, in circumstances where a 10 year trailing average were to be below the prevailing rate, and may be so for some time, we would expect any EDB raising debt

¹ https://comcom.govt.nz/__data/assets/pdf_file/0023/60881/2016-NZCC-20-Cost-of-capital-determination-EDBs-CPP-30-September-2016.PDF

² https://comcom.govt.nz/__data/assets/pdf_file/0029/88724/2013-NZCC-16-Cost-of-capital-determination-for-electricity-distribution-businesses-to-apply-to-a-customised-price-quality-path-proposal-30-September-2013.pdf

³ Fitch Ratings, *Fitch: Negative-Yielding Sovereign Debt Grew to \$10.4 Trn in May* (2 June 2016), www.fitchratings.com/site/pr/1005505

in order to fund substantial investment would be writing to us in similar terms to your letter concerning the *under-funding* implicit in a 10 year trailing average⁴. This underlines the fact that each approach to this topic involves trade-offs for consumers and suppliers.

20. For EDBs, a lower WACC will result in lower revenues than would otherwise be the case. However, this also reflects an economic environment when EDBs' costs are lower, including due to the availability of cheaper financing arrangements. In these circumstances, we would expect EDB shareholders to have revised their assumptions on the returns that could be anticipated, given that the reduction in the risk-free rate incorporated into the WACC is intended to reflect an overall reduction in returns to capital across the economy. As such, shareholders of EDBs should be no more adversely affected in relative terms by this reduction than investors in other types of businesses.
21. As part of our ongoing DPP3 consultation process, we are not aware of any specific and reliable evidence that the current approach under-compensates EDBs such that they would have concerns with their ability to invest. We acknowledge that the current conditions are challenging for businesses. However, our estimate of the cost of capital that applies to EDBs is set at the 67th percentile. This is there to protect against mis-estimation risk, given the potential costs to consumers from under-investment in electricity lines supply. One practical impact of this is that there exists a financial 'buffer' for investors in EDBs.
22. We are extremely concerned by your suggestion that any EDB may take a conscious decision not to undertake the necessary investment across its networks to the detriment of consumers⁵. I can assure you that the Commission would not take a favourable view of any businesses that made such a decision where reduced investment led to less reliable electricity supplies and increased risk to consumers. In the event that an EDB were to contravene its DPP quality standards, we would be very likely to have regard to any such conscious decision to reduce investment when investigating the circumstances of the contravention and considering the appropriate enforcement response.

The claim regarding CPI forecast errors

23. We understand the concerns you raise regarding CPI forecast errors and the potential impacts you believe they can have on the returns of regulated businesses. These concerns were explored in depth at the time of the IM Review and we concluded that continuing with the existing system gave best effect to the purpose of Part 4.⁶ Our main policy decision was and is to provide an *ex post* real return which provides protection for suppliers against inflation turning out differently than forecast and keeps prices constant in real terms for consumers.
24. As we noted at the time, it is not the comparison of the forecast CPI to actual CPI that matters, but the comparison to the implicit inflation forecast inherent in the WACC. During the IM Review we considered alternative forecasts, and none were shown to be superior.⁷

⁴ IM Review Topic Paper 4: Cost of capital issues, para 94.

⁵ While we recognise the shareholders of many EDBs subject to price quality regulation do include consumers, such as via community- or consumer-trust ownership, those businesses are subject to price quality regulation for the very reason that they do not meet consumer-ownership exemption criterion under Part 4, (e.g. where a large number of consumers are not direct beneficiaries of any prevailing trust arrangements).

⁶ IM Review Topic Paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower, paras 254 to 302

⁷ IM Review Topic Paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower, para 297

Options for EDBs to manage external economic factors and to offset impacts on cash flows

25. We note that EDBs have at their disposal various tools and mechanisms to mitigate external economic risks, and the potential impacts these can have on future cash flows.
26. The current WACC represents the conditions for firms raising finance now, and we provide a three month “determination window” prior to the WACC determination being made (i.e. the risk-free rate is estimated based on a three-month average of prevailing interest rates at the time each WACC determination is made).
27. Companies can choose whether to hedge the risk of movements in the risk-free rate and thereby decide the extent to which they will bear the upsides and downsides of the approach they adopt. For example, we are aware that a number of businesses have actively hedged their various debt positions. We understand this has included lining up swap contracts for a given period assuming a 5-year term for the WACC. If the downside risk materialises, it should not just be passed on to consumers unless the upside risk was also passed back to consumers in the past.
28. Many other factors, such as existing debt levels, dividend and retained earnings policies, the ability to raise more equity and any cash requirements or generation of revenues of unregulated businesses, will all influence the treasury policies that each EDB may need to consider in ensuring the future financeability of its business.
29. Your letter implies an assumption that free cash flow for EDBs should be positive in any year (or over a five year period) for infrastructure businesses, and that negative free cash flow in a short period (i.e. over a DPP period of 4-5 years) is undesirable. However, an EDB’s required investment, and therefore funding requirements, may be materially greater than any change in the allowed revenues for a regulatory period. The price paths which are set allow for the costs of financing that investment over its lifetime, but it may not be the case that cash flows in a single regulatory period necessarily exceed all cash outflows for that period.
30. By their nature, infrastructure businesses often have periods of large or elevated levels of investment and/or company activities outside of the regulated services. As you will be aware, there are many reasons for this and could include historic under-investment now requiring significant increases in expenditure, or historic cycles of investment driving renewal and/or system growth requirements.
31. Faced with such lumpy investment profiles, it is not uncommon for infrastructure businesses to raise additional capital through debt or equity raising, or through retained earnings, to fund that investment rather than being able to finance it solely from operating cash flows.

Summary

32. In summary, despite the small window of time remaining before the DPP determination must be published, we have considered the possibility of initiating an IM amendment process. However, for the reasons outlined above, we do not consider that this is warranted in the circumstances.
33. We would like to emphasise that a DPP is not intended to deal with circumstances that require significant scrutiny of the specific needs of an individual EDB across one regulatory period. It remains our firm view that existing tools and remedies already exist within Part 4 to address the concerns raised in your letter. A business can apply for a quality re-opener and/or a CPP where

it does not consider that a DPP meets its specific needs. Such mechanisms can be tailored to meet the specific needs of businesses and the long-term interests of consumers, while also providing the flexibility to generally deal with the key concerns that you have identified to date.

34. I trust that the above assures you that we are aware of the wider economic circumstances facing the electricity sector, and that our position on each of these issues is clear to your members.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S Begg', written in a cursive style.

Sue Begg
Deputy chair