

Notice of revision of cost of capital determination [2017] NZCC 5

Revision of determination

1. On 31 March 2017 the Commission made the cost of capital determination for gas distribution and gas transmission businesses' default price-quality paths (DPPs) for the period commencing 1 October 2017 [2017] NZCC 5 ("**Determination**").
2. The Gas Distribution Services Input Methodologies and Gas Transmission Services Input Methodologies¹ (together, "**Input Methodologies**") set out how cost of capital is to be determined for regulation of gas distribution and gas transmission businesses under Part 4 of the Commerce Act 1986.
3. The Commission has reviewed compliance with the Input Methodologies in setting cost of capital in the Determination, and has concluded that the Determination did not comply with the Input Methodologies in two ways.
4. Accordingly, the Commission has revised the Determination to bring it into compliance with the Input Methodologies. In doing this the Commission has made two changes, which are outlined below.

Changes to Determination

Use of rated bonds

5. The Input Methodologies provide that the vanilla NZ\$ denominated bonds used for estimating the average debt premium must be "investment grade credit rated"² (which is defined as meaning "endorsed with a credit rating by an established credit rating agency (such as Standard and Poor's) of 'investment grade' on that agency's credit rating scale applicable to long-term investments"³).
6. The estimation in the Determination used two bonds issued by Wellington International Airport Limited with maturity dates of 15th May 2021 and 12th May 2023. Although Wellington International Airport Limited is a rated entity, these particular bonds have not been endorsed with a credit rating by an established credit rating agency and so do not meet the definition of "investment grade credit rated". Given that they are unrated, the inclusion of these bonds in the estimation used in the Determination was not in accordance with the Input Methodologies.
7. Accordingly, the revised Determination removes the bonds issued by Wellington International Airport Limited with maturity dates of 15th May 2021 and 12th May 2023.

¹ Gas Distribution Services Input Methodologies Determination 2012 (as amended) and Gas Transmission Services Input Methodologies Determination 2012 (as amended)

² Input Methodologies cl 2.4.4(6)(a)(i)

³ Input Methodologies cl 1.1.4(2)

Interpolation changes

8. The Input Methodologies require us to estimate yields for the risk-free rate and debt premium using bonds with a 5 year term to maturity at the date of the cost of capital determination. The public data available on bond yields do not align precisely with this requirement and so the Input Methodologies prescribe interpolation and averaging techniques in order to obtain an appropriate estimate⁴.
9. The Input Methodologies specify that interpolation should take place on daily estimates *prior to* any averaging process^{5,6}. The approach used in the Determination was not in accordance with the Input Methodologies because we interpolated yield estimates that had been averaged over the relevant reference period.
10. Accordingly, the revised Determination makes a change to the estimation methodology for both the risk-free rate and debt premium so that the interpolation of all daily yield data takes place prior to any averaging process.

Outcome of revision of Determination

11. The change in the 67th percentile vanilla weighted average cost of capital estimate arising from the revision of the Determination is 2 basis points, with the estimate reducing from 6.43% to 6.41%.
12. The revised Determination for cost of capital will be applied in the forthcoming determination of the DPPs for gas distribution and gas transmission businesses for the period commencing 1 October 2017.

Revisions to other cost of capital determinations

13. In due course, the Commission intends to review the cost of capital determination for information disclosure year 2018 for electricity distribution services and specified airport services (March year-end disclosure year) [2017] NZCC 7, to assess whether it also requires revision to comply with the relevant input methodologies. That cost of capital determination will also be revised if necessary.

⁴ Input Methodologies cl 2.4.3 and cl 2.4.4(6)

⁵ Input Methodologies cl 2.4.3(d) and (e) and cl 2.4.4(6)(b)(iii) and (c)

⁶ In addition to the change in the interpolation approach, we also recognised that the annualisation procedure (i.e., the conversion of yields based on quarterly or semi-annual payments to yields based on annual payments) was specified in the Input Methodologies to take place after the interpolation of the bond yields when estimating the risk-free rate. The Determination had not adopted this approach and so we adjusted our approach in this area for the revised Determination. However, this adjusted approach had no material impact on the final estimate of the risk-free rate in the revised Determination.