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

Dear Keston

Input Methodology Review: Cost of capital – response to Technical consultation update paper dated 13 October 2016

Thank you for the opportunity to comment on the information provided in the Technical consultation update paper.

We comment below on three main areas – debt issuance costs, historical averaging approach for estimating the debt premium and aspects of the updated revised draft determinations.

1. Proposal to remove debt issuance costs from the cost of debt

We understand the dilemma presented to the Commerce Commission (Commission) by the wide variance in the views put to the Commission regarding the appropriate amount that should be allowed for debt issuance costs.

We wish to reiterate that, in relation to debt issuance costs, the data cited in Contact's previous submissions is from actual experience that encompasses all actual costs incurred when we issued bonds.[1] We continue to uphold the view that it would be a fair outcome for consumers and regulated entities to set a reasonable, but not overly generous, allowance of 10bp p.a. for debt issue costs.

While we see the intention with the Commission's proposed move to cost recovery, we think it will create more issues, uncertainty, complexity and distortions than the existing methodology and these would outweigh any potential benefits.

The funding portfolios of the larger regulated entities make up the majority of the debt for the sector. These are comprised of a variety of instruments, principally domestic bonds, USPP and bank debt. Under the current methodology, these portfolios are approximated by a hypothetical simple debt portfolio comprising solely of 5 year domestic bonds. We believe this is an appropriate approach, with the tenor and debt premium of 5 year retail bonds roughly equivalent to that the blended average of a more complex portfolio. The debt issuance costs of the hypothetical simple debt portfolio are also a reasonable – though quite conservative – approximation of the debt costs of a blended portfolio. Therefore we see no problem with the Commission's current approach, other than the matter of determining the actual level of costs.

By contrast, the cost recovery approach proposed in the technical consultation paper raises several issues, and we set these out as briefly as we can below:

- For an issuer operating in an open, competitive market, when making a decision about which funding source to select, this is done on the basis of seeking to optimise the all-up cost of funds

[1] http://www.comcom.govt.nz/dmsdocument/14066.

i.e. debt premium and issuance costs combined, in terms of total bp p.a. By splitting the methodology for these two elements, this decision becomes distorted, and may well lead to adverse outcomes for the consumer i.e. the regulated entity might select the funding source with the highest issue cost (that gets fully reimbursed) and lowest margin because this optimises the outcome for shareholders, but combined, these two elements may well produce the highest or sub-optimal overall total cost of debt.

- At the extreme, the structure of funding costs might be deliberately skewed to optimise the outcome for regulated entities, again, at the cost of the consumer. For example, bank pricing could be skewed by having a high upfront fee (which is fully compensated) enabling the ongoing facility fees to be lower (which would maximise the differential between the actual debt premium and the allowed regulatory debt premium). In the case of bonds, the same sort of skew could occur if a very generous amount of upfront brokerage was paid (which is fully compensated) enabling the bonds to be issued at a low debt premium (as the intermediaries at the time of issuance can pass on some of the value of the brokerage to the end investors to adjust the overall return to “normal” by adjusting the price e.g. selling a $1 bond for $0.99).
- For those larger entities with more complex funding portfolios, estimating debt issuance costs over a 5 year horizon may be difficult to do with any accuracy as the choice of funding market at any one time will depending on prevailing conditions at the time of executing the funding. This is likely to mean the estimated debt issue costs provided to the Commission will be very conservative.
- When discussing the proposed cost recovery approach, the Commission does not make reference to the amount of debt for which cost recovery is available, but presumably, there would be a cap on the amount of debt for which issuance costs can be sought that correlates with the leverage allowed for under the IM. Assuming this is the case, there will be an incentive for those regulated entities with gearing in excess of the WACC leverage to allocate the debt with high up front expenses to “regulatory debt” (and be fully compensated for these debt issuance costs) and the debt with low up front expenses to “non-regulatory debt”. In effect, the consumer would bear the cost of the most expensive debt in the portfolio.

Given the above we are concerned about the changed approach to debt issuance costs and recommend these are better dealt with in WACC settings than cost recovery.

Over time it would also be useful for the Commission to accumulate a greater level of information about the actual cost of debt issuance that is being incurred by regulated and non-regulated entities. For this it would be useful to require full disclosure (including evidence) of issuance costs of regulated entities during the next regulatory period. This could help inform the Commission’s view on an appropriate level of debt issuance costs for future periods, along with other market data and input from independent market practitioners.

Attached is a breakdown of Contact’s costs from our recent listed retail bond issue ($150 6.2y bond issued in September 2015). This was Contact’s inaugural FMCA issue so there were some one-off transition costs. Excluding these, the issue costs were 5bp p.a. equivalent for a 5 year bond.

It appears that the main reason for the discrepancy in debt issuance costs across the range of submissions comes from differences in assessed legal fees – here Contact’s actual experience is a very reliable indicator of the true costs – and whether brokerage and Joint Lead Manager fees are payable.

We believe that under normal market conditions, strong investor appetite for a listed, retail, BBB+ rated bond issued by a regulated utility would enable successful execution of bonds without payment of brokerage or firm fees. Contact, Spark, Fonterra and Auckland International Airport have all recently issued bonds with no brokerage or firm fees.

However, we have provided data on Contact's costs in spreadsheet form in this submission (the same data was submitted as a pdf previously) to give the Commission the ability to test alternative assumption, e.g. to test the impact of brokerage. To assist with this, we have calculated average headline brokerage and firm fees on post FMCA issuance for bonds[2] rated BBB to A- as 0.20% total. We note that actual brokerage may be lower than headline as it may not be payable on full issuance volume e.g. institutional bids or exchange offer bids may attract nil or lower brokerage. Institutional bids may make up 30-90% of the total volume.

2. The alternative "historical averaging" approach to estimating the debt premium

Contact has the following comments in relation to the Commission's potential approach to estimating the debt premium:

- We are comfortable with the use of trailing average without a transition period for the debt premium only, noting that this is not an element of the cost of debt that the regulated entities are able to hedge and therefore this approach provides the ability to achieve a natural hedge.
- Contact notes and supports the Commission's use of a 5 year period for a trailing average approach which aligns with the 5 year WACC regulatory periods.
- We note the use of "publicly traded" and "bid" rates and refer to our comments in section 3(i) and 3(ii) below.

3. The revised draft determinations for EDBs, GDBs and Transpower

(i) Use of bid rates

We note that all the definitions / clauses in the draft methodologies that relate to determining the RFR and debt premium are done with reference to the bid rate, which is higher than the mid-rate. This means the RFR input to cost of debt is higher than it should be. In addition, given that corporate bond mid-bid spreads are wider than Government bond mid-bid spreads, this will also have the effect of skewing the debt premium higher than if mid rates were used.

Given the use of the 67th percentile in determining final WACC, and as per our previous submissions on this matter, we strongly recommend the use of mid inputs throughout the methodology generally, and in these instances in particular. The use of a bid rate will have the effect of increasing the RFR and debt premium inputs for the cost of debt, to which a 67th percentile buffer is then added. We think it places an unfair and unnecessary cost burden on consumers if the base WACC has been determined from inputs which "aim high".

(ii) Qualifying bonds

The draft IMs refer to "publicly traded" bonds (for example in the definition of qualifying issuer and in the methodology for estimating debt premium in clause 4.4.4(1) of the Revised Draft Electricity Distribution Services Input Methodologies Amendments Determination 2016).

We think it would be clearer and more precise to specify that bonds must be "listed on the NZDX" or "listed in NZ" rather than "publicly traded". This gives all stakeholders a clearer indication of which bonds or issuers qualify and which don't.

Some bonds – for example those issued to wholesale investors only ("Wholesale Bonds") are not listed on the NZDX, and not available to the wider public to purchase as they are designed specifically for sophisticated, institutional investors only, with typically large minimum parcel sizes of between

[2] Senior, vanilla, non-financial, retail, listed bonds (but excluding Chorus' large, inaugural $400 million bond issue).

$100,000 - $500,000. It doesn't therefore appear that these bonds can be considered to be "publicly traded", but Contact does not think the IMs are sufficiently clear on this matter.

In contrast to Wholesale bonds, listed retail bonds typically have minimum parcel sizes between $100 - $10,000. Retail bonds listed on the NZDX are easily accessible for all investors – both retail and institutional – to trade. Contact considers the IM calculations should be made with reference to NZDX listed retail bonds only and the terminology and definitions in the IMS should reflect this.

The reason this is important is because Wholesale Bonds, with a much smaller subset of potential investors, will trade at a wider debt premium than NZDX listed retail bonds that have a virtually unrestricted universe of investors. If Wholesale Bonds are included in the calculations for debt premiums, this will skew the debt premiums higher (and the same rationale applies when determining any allowance for TCSD).

We note that the requirements for the comparator set (clause 4.4.4(4)) are for the bonds to be "vanilla" and have a qualifying rating and wish to highlight that some bonds that have been used in the Commission's draft / example calculations do not meet these requirements e.g. although Wellington International Airport Limited is itself rated BBB+, not all of its bonds on issue are rated and some are callable. Therefore these bonds do not qualify for the comparator set for determining the debt premium. The lack of a rating and callable feature can have the effect of reducing the potential investor pool (due to some fund mandates not allowing unrated paper or callable bonds), which means the bonds are likely to trade at a wider debt premium than rated bonds assessed to be of the same credit quality (and tenor).

(iii) Ranking of bond spread observations

Contact wishes to make the following comments in relation to the proposed ranking of bond spread observations when the Commission is estimating the BBB+ debt premium (for example, as in clause 4.4.4 sub-clauses (4) and(5)):

- On further reflection, we consider that the Commission should only have regard to bonds that are rated BBB, BBB+ and A-. This group would have an "average" rating of BBB+, consistent with the target rating, but excludes bonds rated BBB-. The reason this is a sensible step is that the debt premium on BBB- bonds, which are just one notch away from non-investment grade, are skewed higher as a result i.e.: the change in debt premium does not behave in a linear fashion relative to changes in rating. There are over a dozen bonds currently listed on the NZDX that would sit within this suggested rating band, from a range of issuers, indicating a sufficiently large comparator set is available from a BBB to A- band:

AUCKLAND AIRPORT	A-
SPARK	A-
FONTERRA	A-
GENESIS	BBB+
MERIDIAN	BBB+
CHORUS	BBB
CONTACT ENERGY	BBB

- Under the streamlined issuance process afforded by the FMCA, the number of relevant issuers and qualifying bonds is likely to grow – for example, there are bond maturities coming up in H1 2017 (Contact, Meridian, Genesis, Vector and Auckland Airport), a number of which are likely to refinance in the domestic capital markets.

(iv) TCSD

As per our previous submissions, we believe introduction of a TCSD is not appropriate, particularly if there is no off-setting adjustment for debt with a tenor shorter than 5 years. Notwithstanding this, Contact has the following comments in relation to the proposed TCSD methodology:

- We believe there should be some materiality threshold applied to tenor compensation, for example, the qualifying tenor should be a material margin over the 5 year threshold (Contact suggests using a minimum of 5.75 years) and a qualifying issuer should have a debt portfolio with a weighted average tenor that is a material margin over the 5 year threshold (again, this could be set at 5.75 years).
- Clauses that clarify tenor (such as 2.4.7(2)(b) should have "required" replaced with "required or made" as it is also relevant if the repayment can be made at the behest of the issuer (not just required by the investor).
- Definition of qualifying debt (such as in clause 2.4.7(1) needs to reference senior, vanilla debt without callable, putable, security, credit wrap etc features.
- It is critical that the Commission uses appropriate bonds for determining any TCSD. The comparator set should comprise senior, rated, vanilla bonds that are listed on the NZDX. Wholesale bonds should not be included. Any bonds that are non-standard market issue sizes should also be excluded as the resultant impact on liquidity means are likely to trade at a wider debt premium than a normal ($50-$250 million) tranche size. The impact of non-standard features or parcel sizes on debt premium is even more exaggerated for longer tenor bonds, so it is important not to include them in comparator sets for TCSD calculations.
- We believe it would be appropriate to add a cap of 1.0 to the RAB ratio component of the TCSD compensation calculation. Compensation should not be based on an assumption for the volume of the long term debt that exceeds the actual amount of long term debt.

Yours sincerely

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