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Keston Ruxton
Manager, Input Methodologies Review
Commerce Commission
By email: im.review@comcom.govt.nz

Dear Keston Ruxton

Input Methodologies Review – Comment on Report by Frontier Economics for Transpower

Background

The Commerce Commission (Commission) in its letter to Transpower dated 14 October 2016 invited further submissions on the memorandum provided by Frontier Economics (Frontier) in support of Transpower's letter dated 5 October 2016, on various post WACC workshop matters.

Benefits of Trailing Average Approach

Wellington Electricity Lines Limited (WELL) agrees with Frontiers' analysis and conclusions, as outlined in Frontier's memo. In their memo Frontier has shown how the trailing average is a better approach to fulfilling the NPV = 0 principle. In respect of existing investments, the trailing average approach is NPV neutral because the regulatory allowance always matches the efficient cost of debt. By contrast, the rate on the day approach violates the NPV=0 principle, due to the mismatch between the allowed and efficient debt risk premium (DRP). Frontier's memo notes that the conclusions in Dr Lally's appendix[1] are flawed because of particular erroneous assumptions embedded within the analysis, such as:

- considering only the DRP portion of the costs (with no consideration given to the larger mismatches on the risk free rate component); and
- focussing only on the capital expenditure portion of investment (which is only a fraction of the Regulated Asset Base (RAB)).

Frontier concludes that the NPV=0 violation that arises under the rate on the day approach can be very large in respect of all existing assets. No such violation arises under the trailing average because the regulatory allowance will always align with the efficient cost of debt. Further, the violations that occur in relation to the base risk free rate can have a larger magnitude and this risk is minimised under the trailing average approach. To the extent that the analysis of mismatches is relevant, it favours the trailing average approach.

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[1] Lally, M., 2016, Review of further WACC issues, 22 May.

We have continued to advocate the benefits of adopting a trailing average approach to setting the cost of debt under the DPP and CPP. A trailing average approach is consistent with the debt management practices of a business operating in a competitive market. In particular, it aligns with the staggered approach a prudent business is required to take for mitigating refinancing risks. The trailing average approach, therefore, promotes an outcome that is consistent with the intent of the Commerce Act to enable workably competitive outcomes.

The Australian Electricity Regulator (**AER**) also considered these issues in moving from 'on the day' approach to a trailing average approach in its 2013 Rate of Return Guideline. Specifically, the AER concluded the following (with emphasis added):

> *We propose to apply a trailing average portfolio approach to estimate the return on debt. This approach means that the allowed return on debt more closely aligns with the efficient debt financing practices of regulated businesses and* ***means that prices are likely to be less volatile over time. The trailing average would be calculated over a ten year period.*** *The annual updating of the trailing average should also reduce the potential for a mismatch between the allowed return on debt and the return on debt for a benchmark efficient entity.*
>
> *In addition to the considerations above, the trailing average portfolio approach provides the following benefits:*
>
> - *It smooths movements in return on debt over a number of years. We consider this would result in lower price volatility (from one regulatory control period to the next) for energy consumers and more stable returns for investors than the 'on the day' approach. Consideration of consumer price volatility is an important factor, since the price volatility affects intertemporal decisions of energy consumers and hence affects the overall efficiency of economic outcome.*
> - *It minimises the consequences of a single measurement error.*
> - *It may be more reflective of the actual debt management approaches of non-regulated businesses. It might, therefore, be more likely to represent efficient financing practices.*

Our Proposal

We consider that the benefits of a trailing average approach to setting the cost of debt allowance are compelling. The input methodology review provides a clear opportunity to revisit the Commission's current approach and ensure that businesses are adequately financed and resilient to adverse market conditions. The Commission is aware of the benefits from prudent businesses raising long term debt, which is consistent with the long lives of assets and reduces refinancing risk.

As noted at the WACC workshop there appears to be consistency amongst all submitters that the trailing average is a materially better approach compared with the rate on the day. The only points of disagreement is the period over which the trailing average should be set (5 years or 10 years) and whether a split trailing average approach for just the debt risk premium is an option (as requested by the Commission, WELL will comment on this in response to the technical consultation).

As the Commission knows, WELL recommends the use of a 10 year trailing average period as it smooths out the short term market volatility in prices to consumers and reflects the average tenor of efficient financing practices, particularly where debt

capital is financing long lived assets. We believe that it is important for the Commission to recognise the benefits from EDB's staggering their debt maturities over a longer period in terms of stability in prices. In setting the IM's, the long term benefits to consumers is a key consideration and a WELL considers that a 10 year averaging period better meets this criteria when compared to a 5 year period.

However, we recognise that the Commission may have a view on the need for EDBs to unwind their existing hedges before they can be compensated for a full trailing average methodology. As a secondary alternative, we consider the hybrid approach (as outlined in the technical consultation) as the optimal approach, compared with rate on the day. This would enable EDBs to move to a trailing average debt risk premium (that has not been previously hedged) and continue to hedge the risk free rate component of the cost of debt. To the extent the Commission considers there are limitations to moving to a trailing average approach, it may consider a transition from hybrid method to trailing average over the future regulatory periods. We will expand on this in our subsequent submission on the technical consultation.

Conclusion

WELL supports the analysis and conclusions contained in Frontier's memo, notably that the trailing average approach is superior to the rate on the day approach. However, to the extent the Commission considers it important to unwind existing hedges, we recommend adopting the hybrid approach with a view to transitioning to a full trailing average approach over future regulatory periods.

Yours faithfully

Greg Skelton
CHIEF EXECUTIVE OFFICER