BARNZ
BOARD OF AIRLINE REPRESENTATIVES NEW ZEALAND INC

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Keston Ruxton
Manager IM Review
Regulation.branch@comcom.govt.nz

Dear Keston

THE USE OF TRAILING AVERAGES

One of the specific areas of focus identified by the Commission in the update paper on the cost of capital topic is the use of trailing averages as an alternative to prevailing rates in calculating the risk-free rate and/or debt premium. BARNZ wishes to comment on this area.

BARNZ does not support the use of a trailed average

WACC is predominantly a forward looking concept, designed to identify the cost of capital to a firm going forward, and to provide a measure of the opportunity cost to the firm of using its capital for the particular activity in question, rather than investing in an alternative activity. Since debt costs change with financial market conditions, the average historic cost of debt, taken by itself, is therefore a poor indicator as to the cost of capital a firm is facing when making forward looking investment decisions in respect of the forth-coming pricing period.

If the choice is solely between a forward looking rate, or a trailed average rate, then BARNZ supports the approach adopted by the Commission in the UCLL and UBA decisions of using prevailing interest rates, determined as close as practicable to the beginning of the regulatory period, given this more accurately reflects expectations in the financial markets at that time, which provides appropriate signals to suppliers and consumers.

It has been BARNZ's experience that during price resetting when the prevailing cost of debt is increasing, that suppliers are only too happy to make use of the prevailing rates. The fact that at times a significant portion of the firm's debt requirements has been fixed at the previously lower rates, enabling the firm to recover more than its actual costs of debt, has not previously been seen as relevant by suppliers with whom BARNZ has consulted over the re-setting of charges.

It is only now that prevailing debt rates are below average debt rates experienced over the last ten to fifteen years, that the concept of a trailing average is being promoted by some regulated suppliers.

If any change of approach is adopted, it must be one which does not systematically advantage either suppliers or consumers. If a change is adopted, it must be applied going forward on a principled basis, with the approach applied consistently, irrespective of whether the trailed average is above or below prevailing debt rates. Suppliers should not be permitted to pick and choose which approach to use.

Level 12, BDO Tower, 120 Albert St, PO Box 2779, Auckland 1140, NZ
Phone: 09 358 0696 Fax: 09 358 0697 Email: admin@barnz.org.nz www.barnz.org.nz

A potential hybrid alternative approach

As noted above, BARNZ does not support the use of trailed averages, especially ten year trailed averages.

However, BARNZ has previously proposed a hybrid approach to the calculation of the cost of debt (which was at the time rejected by both BARNZ's WACC advisor as well as the WACC advisor of the airport in question). Given that the Commission has asked for views on the use of trailing averages, we reset out our previously proposed alternative approach, and invite consideration and comment by representatives of suppliers, consumers and the Commission.

Our alternative approach is that the cost of debt could be calculated by combining historic and forward looking risk free rates and debt premiums using a ratio reflecting the proportion of debt that an efficient firm would have fixed during the previous pricing period, as against the proportion of debt that an efficient firm will need to renew during the new pricing period:

- The historic risk free rate and debt premium would be determined as the average risk free rate and debt premium applicable during the previous pricing period (possibly calculated to give greater weighting to rates applying in the later years of the pricing period rather than the earlier years of the pricing period); and
- The forward looking risk free rate and debt premium would be determined by taking the current prevailing risk free rate and debt premium from as close as practicable to the date charges are being reset (say the average over the month ending two weeks prior to the charge setting decision).

By way of example, if the average risk-free rate plus debt premium over the last regulatory pricing period was 7%, but the prevailing rate is 8%, then assuming (for simplicity) that an efficient firm would have fixed half of its debt requirements during the previous regulatory period, and would need to obtain the other half of its debt requirements during the forthcoming regulatory pricing period, then the cost of debt would be 7.5%. On the other hand, if the prevailing rate was 6%, which is lower than the 7% average risk-free rate plus debt premium over the last regulatory pricing period, then the cost of debt would be 6.5%. (Note that if the Commission determined that an efficient firm would only have committed to (say) 40% of its debt funding requirements during the last regulatory pricing period, then the calculations would need to be based on 40% of the historic rate and 60% of the prevailing rate.)

This approach reflects the fact that, in the real world, firms have debt maturing, and needing to be refixed, continuously. Firms do not have all their debt maturing at the end of one regulatory pricing period, needing to be refixed at the commencement of the next period. At the beginning of the pricing period, a firm will have a certain amount of its forward looking debt needs which have been fixed during the previous pricing period.

This debt will most likely be at a different rate (on average) to that currently prevailing. If debt rates have subsequently increased, then using prevailing debt rates to the exclusion of what applied during the previous pricing period, will provide a wind-fall gain to suppliers, and will result in consumers paying more than necessary to cover the costs of the debt previously incurred by the suppliers. If, on the other hand, the prevailing cost of debt is lower, consumers will be advantaged,

and suppliers may not recover the actual cost of the debt they had incurred. Taking into account the historic cost of debt, applying during the previous pricing period, for the proportion of debt that an efficient firm would have fixed during the previous pricing period, means that neither the suppliers nor the consumers receive as much of an advantage or disadvantage as a result of movements in the prevailing debt rate subsequent to the debt being fixed.

Such an approach would promote the outcomes sought by s52A, in particular:

- Strengthening incentives to invest because firms will know that the cost of debt component of the WACC calculation will proportionally reflect historic financing commitments which a hypothetically representative efficient firm would have made, even if those commitments were made at interest rates greater than those currently prevailing;
- Sharing with consumers the benefits of efficiency gains anticipated to be achievable by an efficient firm through appropriate management of funding as well as limiting the likelihood of excess profits being extracted if the prevailing cost of debt is greater than that applying to previously made financing decisions.

Concluding comment

We appreciate that what we have outlined above is an alternative approach to those discussed in the Commission's Update Paper, however we hope that it provides an insight into a solution that one group of acquirers of regulated services believes would provide an appropriate balance between the interests of suppliers and acquirers as identified in s52A(1), thus contributing to achieving the overall purpose of Part 4 of promotion of the long term benefit of consumers.

Yours sincerely

John Beckett
Executive Director