Submission on Part 4 input methodologies review – draft decisions

19 July 2023

CHORUS

Overview

1. This is Chorus' submission on the draft decisions published by the Commerce Commission (**Commission**) on 14 June 2023 for its 7-yearly review of input methodologies (**IMs**) under Part 4 of the Commerce Act 1986 (**Part 4**).

2. We confirm that this submission can be published on the Commission's website, and that no part of this submission contains confidential information.

3. Our views on the IM changes needed to ensure materially better IMs for Part 4 regulation are summarised in the table below.

	Chorus submission	Supporting reasoning
1	Chorus recommends moving to a **full trailing average approach** for the risk-free rate in the Cost of Capital IMs	A full trailing average approach provides a stable and commercially realistic weighted average cost of capital (**WACC**), and appropriately reflects the practicalities of debt portfolio hedging in New Zealand markets.
2	Chorus recommends moving to a **Total Market Return (TMR) approach** for estimating equity costs in the Cost of Capital IMs	Deriving the tax adjusted market risk premium (**TAMRP**) as a residual from a stable TMR is better than the current 'averaging' method because it will increase the stability and accuracy of the cost of equity estimate.
3	Chorus agrees that a **CPI wash-up** should apply, including for year 1 of a regulatory period, in the Specification of Price IMs	A CPI wash-up protects suppliers and consumers from negative impacts of inflation shocks, allocates inflation forecasting risk appropriately and better promotes incentives for efficient investment through real FCM.
4	Chorus recommends maintaining **inflation protection for debt costs** in the CPI wash-up in the Specification of Price IMs	Maintaining inflation protection for debt costs ensures the CPI wash-up is effective across the entire regulatory asset base (**RAB**) – not just the portion notionally funded by equity. This best allocates forecasting risk.
5	Chorus agrees that **opex solutions** (and 'consequential' opex or capex) should be in scope for capex approval/reopener IMs	Including opex solutions (and 'consequential' opex or capex) reflects the reality of efficient investment decision-making; flexibility ensures the broadest range of solutions are considered – useful in periods of change.

4. Below is a summary of our views on other draft decisions of the Commission.

	Topic/issue	Suggestion/comment
6	Expanding the scope of the **innovation allowance scheme**, and making it tailored/flexible to better suit various projects	It is critical that the scheme remains workable, low cost, predictable, and broadly accommodating; some simple changes to existing settings, and allowing those to be adjusted periodically, could encourage uptake.
7	Retaining the existing **Incremental Rolling Incentive Scheme (IRIS) scheme**, with some technical refinements	We are concerned there are no new proposals to improve the scheme and make it more comprehensible; to provide an effective incentive, the scheme must allow decision-makers to fully understand its implications.

8	Maintaining the current policy framework and various measures available for **mitigating stranding risk**	We support the availability of the entire suite of risk mitigation measures to support real financial capital maintenance (**FCM**); mitigation settings need regular adjustment for up-to-date information.

Materially better IMs for Part 4 regulation

Increasing accuracy and stability of financing cost estimates

5. The IM review has considered whether the cost of capital IMs can be improved to provide a more stable and commercially realistic WACC, particularly in light of significant recent divergences in forecasts of the risk-free rate vs out-turn. More stable and predictable cost of capital settings would provide suppliers increased confidence to invest and innovate for the long-term benefit of consumers.

6. In July 2022 we submitted an expert report from Incenta that demonstrated that the stability of WACC estimates can be improved with some easy-to-implement changes to the cost of capital IMs. Specifically, an IM that materially better meets the purposes of the IMs and Part 4 would require:[1]

   a. **Adopting a full trailing average approach** – for estimating the cost of debt, replacing the current prevailing rate (3-month average) methodology that applies to the risk-free rate, with a trailing average that reflects the average term of debt that an efficient firm would face (e.g. 5 or more years); and

   b. **Adopting a Total Market Return (TMR) approach** – for estimating the TAMRP, refining the current method in the cost of capital IMs such that the TAMRP is derived as a residual from a stable TMR and a risk-free rate of return. This is the standard approach adopted by all UK regulators.

7. The Commission has rejected adopting the above approaches and proposed retaining the status quo. It has dismissed the idea that limitations of the New Zealand swaps market mean it should depart from its hybrid approach for estimating the cost of debt and move to a full trailing average approach instead.[2] It has also stated that the TMR approach is closest to placing all reliance on the Siegel (v2) and DGM approaches but has not provided reasons why it should not move to, or place more weight on, the TMR approach.[3]

8. We disagree with the reasons for not adopting the full trailing average approach and believe it would materially better achieve the purposes of the IMs and Part 4:

   a. The hedging activity assumed by the Commission, in support of retaining the hybrid approach to estimating the cost of debt, is impractical for large, regulated firms. The Commission recognises that staggering debt maturity dates is an efficient financing strategy that reduces refinancing risk, consistent with Chorus' view. While the Commission provides evidence that regulated firms are able to

[1] Incenta, Measures to improve the stability in WACC estimates, July 2022.
[2] Commerce Commission, Draft decision Cost of capital topic paper, 14 June 2023 [at para 3.63]
[3] Commerce Commission, Draft decision Cost of capital topic paper, 14 June 2023 [at para 4.189-4.193]

use swaps,[4] the evidence does not prove that most firms do that, or that large firms use swaps to reprice all their debt;

b. There is clear support from regulated firms across multiple sectors to move to a full trailing average approach.[5] In addition to aligning to efficient debt financing strategy, submissions supported moving to a trailing average to reduce price path volatility *across* regulatory periods. We note that the Commission did not address these concerns, rather it pointed to proposals that affect price path volatility *within* regulatory periods.

9. In respect of the TMR, we agree that the TMR approach is consistent with the Siegel (v2) method. However, that does not equate to placing all reliance on it for the TAMRP estimation. Incenta's proposal was to estimate the TMR when deriving the cost of equity and to allow the TAMRP to be determined as a residual (i.e. dependent on the level of the risk-free rate). This would result in the methodology for the TMR being prescribed in the IMs, with the TAMRP being calculated at the time of each cost of capital determination. To support this the Commission would interpret history by looking at the TMR rather than TAMRP.[6]

10. There is little reason provided by the Commission for why retaining its existing 'averaged' method of estimating the TAMRP better meets the purposes of the IMs or Part 4 than the TMR approach suggested by Incenta. Rather, we consider the report produced by Incenta demonstrates the TMR approach would be materially better at meeting these purposes. Key new evidence that Incenta provided in 2022 which supports this includes:

    a. That UK and Italian regulators have preferred using the TMR;[7]

    b. Analysis indicating that New Zealand experts implicitly use the TMR;[8]

    c. The observation that estimating the cost of equity using a combination of the prevailing risk-free rate estimate and the Commission's current approach to estimating the TAMRP resulted in additional volatility to Chorus' returns.[9]

11. We recommend the Commission revisits its draft decisions; Incenta's recommended approaches to the cost of capital IMs promote a stable WACC that better reflects real-world financing conditions that efficient firms can reasonably be expected to face. Incenta's refinements would improve how the cost of capital IMs allocate risk, achieve an expectation of ex-ante real FCM, and promote price stability. Collectively, these refinements would materially better meet the purposes of the IMs and Part 4 than those in the cost of capital IMs.

Protecting against inflation forecasting risk

12. We support the Commission's draft decision to protect suppliers and consumers against inflation forecasting risk for price-quality (**PQ**) paths, including closing the

[4] Commerce Commission, Draft decision Cost of capital topic paper, 14 June 2023 [figure 3.1]
[5] Commerce Commission, Draft decision Cost of capital topic paper, 14 June 2023 [at paras 3.30-3.44]
[6] As an example, the Commission could continue to consider the survey of market practitioner assumptions that is undertaken by Fernandez; however, the Commission would use the practitioner assumptions about both the market risk premium and risk-free rate when estimating the TMR, and in doing so would apply the full context of those practitioner assumptions.
[7] Incenta, Measures to improve the stability in WACC estimates, July 2022 [at section 3.3]
[8] Incenta, Measures to improve the stability in WACC estimates, July 2022 [figure 8]
[9] Incenta, Measures to improve the stability in WACC estimates, July 2022 [at section 3.2]

'gap' for the first year of a regulatory period (which was an historical anomaly without an underlying policy rationale), via a maximum allowable revenue (**MAR**) wash-up for CPI. Having such a wash-up protects suppliers and consumers from the negative impacts of inflation shocks, allocates inflation forecasting risk appropriately and better promotes incentives for efficient investment.

13. We disagree with the draft decision to exclude inflation protection for debt costs in the new MAR wash-up (via a specific offsetting wash-up item). A materially better IM would maintain inflation protection for the portion of the RAB notionally financed by debt (or at least give suppliers the option to do so), ensuring the CPI wash-up applies across the whole RAB, not just the portion notionally funded by equity. The key reasons for maintaining inflation protection for debt costs are:

    a. Removing inflation protection from the portion of the RAB financed by debt is inconsistent with providing real returns to regulated firms, allocating inflation forecasting risk to consumers and promoting outcomes expected in workably competitive markets.[10] In the 2016 review the Commission confirmed that its approach:[11]

       "offers an ex-ante expectation of a real return (or real FCM), and delivers an ex-post real return (or real FCM). This results in an outcome where both consumers and suppliers are protected from inflation risk."

       The Commission's draft decision has not explained how removing inflation protection from the price path for debt costs is consistent with these principles.

    b. The Commission has not presented material new evidence for removing inflation protection for debt costs since the 2016 IM review. During the 2016 IM review, the Commission considered the role of the inflation wash-up to the revenue path in combination with RAB revaluations and considered that the residual bankruptcy risk to regulated providers was small.[12] While out-turn inflation has been significantly higher than forecast inflation in recent years this does not mean that inflation protection should be removed.

    c. The decision to remove inflation protection from the portion of the RAB financed by debt is inconsistent with other draft decisions in this IM review which support increasing inflation protection.[13]

    d. The Commission has already acknowledged that staggering debt maturity dates is an efficient financing practice. A result of having staggered debt maturity dates is that the observed cost of debt varies across each year.

    e. The Commission notes, in several places, that failing to account for its assumption that debt is financed in fixed rate nominal terms will result in windfall gains or losses, as well as additional stability. However, this characterisation is misleading – full correction for inflation merely preserves

[10] Commerce Commission, Form of Control and RAB indexation for EDBs, GPBs and Transpower, 20 December 2016 [at para 270]
[11] Commerce Commission, Form of Control and RAB indexation for EDBs, GPBs and Transpower, 20 December 2016 [at para 261]
[12] Commerce Commission, Form of Control and RAB indexation for EDBs, GPBs and Transpower, 20 December 2016 [at paras 267-268]
[13] Commerce Commission, Draft Decision Financing and incentivising efficient expenditure during the energy transition topic paper, 14 June 2023 [at paras 5.69.2-5.69.4]

the real return on capital and provides for stability of revenue – and hence prices – in real terms. There is no economic windfall across the asset base, and stability in real terms (rather than in nominal terms) is in consumers' interests given the tendency for incomes to track inflation (at least in the medium term). While inflation forecasting errors may create transfers between different providers of finance (depending on how firms choose to finance), we submit that such transfers between different types of investors should not be the Commission's concern.

f. Moreover, as noted previously, the Commission's assumption that inflation forecast errors will necessarily create a surplus or shortfall in terms of debt financing is based on the assumption that firms can use swaps to "lock in" 100% of their debt costs consistent with interest rates at the start of a regulatory period. But this assumption is flawed – Chorus, for instance, does not, and cannot, hedge interest rates in this manner, and we expect the same outcome would apply for some of the firms regulated under Part 4.

14. In terms of how the Commission intends to implement the additional correction for inflation in the proposed Specification of Price IM drafting, we note that there is a potential inconsistency between the draft reasons paper (which suggests that the existing wash-up at the revenue level will be extended by a year) whereas the drafting in the IMs would require a re-running of the MAR model and updating the values of building blocks that include inflation assumptions.[14] Assuming the latter method is to be followed however, we have some comments on the proposed Specification of Price IM drafting:

a. The drafting requires actual inflation to be substituted for forecasts in the MAR model for all purposes except for calculating RAB revaluations. We do not think revaluations can be excluded from the correction in this manner (as an error in the revaluation for year 1 will flow through to the return on assets/depreciation line items for subsequent years).

b. We suggest additional clarity is added to the proposed Specification of Price IM drafting as to which forecasts are captured, to ensure the proposed wash-up operates effectively as intended. The current drafting requires substituting "actual CPI for forecast CPI" when recalculating forecast allowable revenue. This appears to exclude building block items that are dependent on inflation forecasts such as the Producers Price Index (**PPI**) or Capital Goods Price Index (**CGPI**), which as specific (and appropriate) measures of input inflation should be covered by the wash-up.

c. Additional clarity could also be added to avoid the uncertainty which is likely to arise given the complexity of the modelling that underpins PQ decisions. For example, whether calculating the MAR on the "same basis as the forecast allowable revenue" extends to recalculating the nominal values of supplier-produced forecasts of opex or capex dependent on cost inflators, obtained by the Commission through information requests or from Asset Management Plans (as opposed to those inputs explicitly labelled as reliant on 'CPI' in Commission-published models).

[14] Commerce Commission, Draft decision Financing and incentivising efficient expenditure during the energy transition topic paper, 14 June 2023 [at para.5.100]; [Draft] Electricity Distribution Services Input Methodologies (IM Review 2023) Amendment Determination 2023, 14 June 2023 [at clause 3.1.4(4)]; [Draft] Gas Transmission Services Input Methodologies (IM Review 2023) Amendment Determination 2023, 14 June 2023 [at clause 3.1.4(4)].

Allowing for opex solutions and 'consequential' spend

15. We support including operating expenditure (**opex**) solutions as an alternative to capital expenditure (**capex**) in various capex approval IMs and in considering MAR adjustments in PQ path reopeners. This reflects the reality of efficient investment decision-making – where the flexibility to include opex ensures the broadest range of solutions are available to capture optimal outcomes – and is particularly useful in periods of significant change in markets or in external conditions. Additionally, as the Commission notes, it avoids capex bias.

16. We also support the Commission's proposal to allow both 'consequential opex' and 'consequential capex' to be considered in major capex approvals for Transpower and in reopeners for EDBs and GPBs. It is reasonable to allow one-off and/or ongoing costs, incremental to existing approved allowances, that are caused by, or reasonably necessary to support, the primary project or programme under consideration. The amounts involved are often material and unavoidable for suppliers, so their inclusion supports real FCM and maintains investment incentives.

Other suggestions on Part 4 IM draft decisions

17. Chorus makes the following suggestions for the Commission's other draft decisions:

    a. **Innovation allowance scheme** – we support an expanded and more flexible innovation allowance scheme. Considering the nature and needs of innovation projects themselves – which often have short lead times, and, by definition, embrace uncertainty – it is critical that the mechanism remains workable, low-cost, predictable and broadly accommodating of a range of project types.

       Rather than introducing further complexity (e.g., setting penalty and reward mechanisms), some simple changes to existing settings (and the ability to review these periodically as part of setting the PQ determination) could better suit some suppliers – streamlining processes, reducing risk, and providing greater predictability to remove perceived barriers. For example:

        i. Lowering the percentage of minimum costs borne by the supplier (e.g., to 10%) – allowing a supplier's own assessment of (uncertain) benefits to fare better against (known) costs when deciding whether to proceed.

        ii. Providing for an upfront and non-binding indication to be provided by the Commission (within a certain time frame, and with appropriate confidentiality) before a proposed project is embarked upon as to whether it will qualify for funding under the scheme.

        iii. Waiving the requirements for advance specialist reports to be prepared for small-scale projects or some types of research, evaluation or testing, and focussing on the aims and intentions of a project, rather than ex post evaluations of success.

        iv. Including small-scale sustainability projects or trials aimed at increasing energy efficiency, reducing carbon emissions, or other environmental improvements relating to service provision.

b. **IRIS scheme for energy sectors** – a number of technical changes to the existing IRIS IMs/mechanisms have been proposed by the Commission, but there are no proposed solutions for reducing the practical complexity of the scheme. An incentive scheme, and its implications for a supplier, must be fully understood by the decision-makers to whom it is directed in order to be effective. We recommend the Commission further considers ways of simplifying the scheme and/or making it more comprehensible to achieve its intended purpose.

c. **Maintaining approach to mitigating stranding risk** – We agree with the Commission's framing of the policy problem and possible solutions in this area, and of the general need to address stranding risk using the full suite of mitigation and ex ante compensation measures available under the building blocks model – preserving expectations of real FCM for investors and allocating risks efficiently.

   We suggested previously that assessing ex ante allowances at each PQ reset to estimate risk based on current information/expectations (e.g., Chorus' 10 basis points per annum allowance specified in the fibre IMs) strikes the right balance, and is the materially better approach to ensuring allowable revenues accurately reflect risks investors are exposed to over the lifecycle of assets.[15]

[15] Risks include new or previously unquantified uncertainties arising from the impact of impact of climate change and the transition to a low carbon emissions economy, changing consumer preferences, new technologies, government policies, ongoing impact of COVID-19 and other global/national issues (where not compensated for by the WACC).