Wellington Electricity
Lines Limited
75 The Esplanade
Petone, PO Box 31049
Lower Hutt 5040
New Zealand
Tel: +64 4 915 6100
Fax: +64 4 915 6130
www.welectricity.co.nz

9 February 2016

Keston Ruxton
Manager, Market Assessment and Dairy Regulation Branch
Commerce Commission
By email: regulation.branch@comcom.govt.nz

Dear Keston Ruxton

Input Methodologies review – Cost of Capital

1. Introduction

Wellington Electricity Lines Limited (**'WELL"**) welcomes the opportunity to respond to the Commerce Commission's (**"Commission")** consultation paper *'Input methodologies review – Update paper on the cost of capital topic'* published on 30 November 2015.

WELL has engaged extensively in the preparation of and endorses the submission made by the Electricity Networks Association ("ENA") and the accompanying independent expert report prepared by Competition Economists Group ("CEG"). In addition to the ENA submission, WELL outlines below its views on the key topics that should be further evaluated as part of this opportunity to improve the Input Methodologies ("IM's") for the Weighted Average Cost of Capital ("WACC"). WELL has attached to this submission a number of recent expert opinions from Australia that it considers are informative for the Commission as it evaluates the WACC IM's.

The Commission will appreciate that electricity distribution networks are capital intensive with long lived assets and therefore a material aspect of the Commission's DPP and CPP IM's is the allowed WACC return on the capital invested by our business. An efficient allowed WACC is particularly important for both the long term benefit of consumers and the sustainability of critical network investment. Consistent with section 52A of the Commerce Act, WELL considers that the optimal cost of capital is one that:

- ensures consumers are protected from inefficient and overinflated prices;
- allows businesses to earn an efficient return on investment that provides incentives to innovate and invest in replacement, augmentation and installation of new assets;
- encourages efficient and regular investment avoiding price shock cycles that go with periods of under and over ("catch up") investment; and
- rewards prudent debt management strategies that are consistent with outcomes produced in competitive markets.

WELL considers that the methodology specified in the current IMs for determining the WACC has resulted in highly volatile, inefficient and unreliable estimates of the cost of capital, for which there are viable alternatives that will improve on these shortcomings. The current IM methodology resulted in a mid-point WACC estimate of 8.05% in 2009 which dropped to 6.21% in 2012, rose to 6.72% in 2014 and again dropped in 2015 to 5.57%. WELL welcomes this opportunity and encourages Commission to develop methodologies that result in more robust and stable estimates of both cost of equity and cost of debt, which are less variable with day to day fluctuations in financial markets.

2. Cost of Equity

When assessing whether the current approach is sensible and robust, it is informative to consider what cost of capital allowances the approach would have delivered if it had been employed over a number of years. The Commission's current approach to setting the cost of equity allowance is directly related to New Zealand government New Zealand dollar denominated nominal bond yields and moves in lock step with movement in the yields of these bonds. To ensure that the cost of equity allowance is commensurate with market returns, reduces volatility and accounts for new risks faced by the industry from emerging technologies, the Commission should amend its methodology for determining the cost of equity by having regards to the following:

1. Apply SBL-CAPM but adjust for the downward bias in SBL-CAPM. A recent precedent for this approach is the Australian Energy Regulator (AER) who also applied the theory of Black CAPM in determining the beta estimate by selecting beta at the top of its range of estimates in its Rate of Return Guideline and regulatory determinations.

2. The tenor for risk free rate used for determining the cost of equity should be **10 years** rather than 5 years for both DPP and CPP (irrespective of the whether the CPP is applied to 3, 4 or 5 year period). The rationale for a longer period is supported by other international regulatory regimes as highlighted in CEG report for the ENA.[1] The ENA Australia commissioned Incenta Economic Consulting (Incenta)[2] to provide an expert opinion on the term of the risk-free rate. Incenta (2013) concluded that:
    - Theory provides no particular guidance about the appropriate term of the risk-free rate.
    - The Sharpe-Lintner CAPM (which is one of the theoretical models that may be used) is a one-period model where the length of the period equals the lives of the assets;
    - The approach of setting the term of the risk-free rate to the five-year length of the regulatory period, while estimating market risk premium with reference to a ten-year risk-free rate would be internally inconsistent;
    - The dominant market practice is to set the term of the risk-free rate to ten years when evaluating regulated and unregulated infrastructure businesses.

   Further, SFG Consulting (SFG) concluded that it is not necessary to set the term of the risk-free rate to the length of the regulatory period to preserve any NPV=0 principle, were this to be the accepted objective.[3]

   The ENA Australia also commissioned SFG to examine the practice of independent expert valuation professionals. SFG showed that[4]:
    - The almost universal practice of independent expert valuation professionals is to use a 10-year term to maturity when estimating the risk-free rate in asset-pricing models; and
    - The only deviation from that dominant practice occurs where the expert notes that the life of the assets being valued is less than ten years.

   The Australian Energy Regulator (**AER**) in its rate of return guideline and its determinations for Australian distributors concluded that the 10 year Commonwealth Government Securities (CGS) should be used for estimating the risk free rate. WELL considers there is a strong case for extending the risk free rate from 5 years to 10 years when determining the cost of equity.

1 CEG, Key reforms to the rate of return under the IMs, 2016

2 Incenta, Term of the risk-free rate for the cost of equity, June 2013.

3 SFG, Response to QCA approach to setting the risk free rate, Report for Aurizon Ltd, March 2013.

4 SFG, Evidence on the required return on equity from independent expert reports, June 2013.

3. WELL has considered the Commission's approach in the Chorus determination and has concerns about the use of Siegel version 1 method. WELL encourages the Commission to consider the report submitted by SFG on behalf of Aurizon Ltd to Queensland Competition Authority (QCA) that looks at the short coming of this approach, giving higher weighting to historical measures and also using a median estimate.[5]

4. Consistent with CEG's empirical finding in its report prepared for the ENA, WELL considers there is no basis for changing the asset beta due to a change in the form of control.[6] This is also consistent with AER's approach for not adjusting the asset beta when changing the form of control for Victorian electricity distribution businesses from a price cap to a revenue cap. In addition, WELL recommends that the Commission should take a holistic approach and consider the impact of the new risks, complexities and uncertainties faced by electricity distribution businesses as a result of emerging technologies. WELL supports CEG's conclusion that a reasonable mid-point estimate for asset beta based on empirical analysis is 0.36 to 0.38.

5. The Commission should provide the businesses with an allowance for equity raising costs. These are costs incurred by service providers in raising equity from outside the business (dividend reinvestment plans and seasoned equity offerings). The AER in its October 2015 draft decision for Victorian businesses mention that *"Equity raising costs are an unavoidable aspect of raising equity that would be incurred by a prudent service provider acting efficiently. Accordingly, we provide an allowance to recover an efficient amount of equity raising costs"*. WELL recommends that the Commission follow this precedent and provide an allowance for these costs.

3. Cost of Debt

WELL's key concerns around the cost of debt are:

- the volatility in cost of capital estimate as a result of the current IM methodology;
- the narrow time period for the risk free rate re-set; and
- the risk of market distortion that exists with multiple EDB's and Transpower looking to hedge their interest rate risk in the same narrow pricing window.

To address these risks, WELL favours the implementation of a 10 year trailing average approach to setting the cost of debt. This is also consistent with business' practice under a workably competitive market, where businesses are maintaining staggered debt maturity portfolios that reduces refinancing risks and the need for hedging.

The current IM approach is not reflective of a practical debt management practice and is not replicable by businesses. This is because the methodology assumes that businesses raises all its debt required to satisfy its financing needs once for every regulatory period just ahead of the start of each regulatory period, which is unrealistic as infrastructure businesses tend to stagger their debt over a long period of time to reduce refinancing risks. CEG, in its report to AER on behalf of Victorian businesses stated that *"It did not reflect the costs of a viable debt management strategy and, every time a regulatory decision was made, a business and its customers were subject to what was, in effect, a roll of the dice"*.[7] WELL supports CEG's conclusion that the

5 SFG, Response to QCA Discussion Paper on risk free rate and market risk premium, Report for Aurizon Ltd, March 2013.

6 CEG, Asset Beta, Report for ENA, 2016.

7 CEG, Critique of AER's JGN draft decision on the cost of debt, 2015.

Commission should therefore first establish a benchmark debt management strategy that businesses could practically replicate and then use this to determine the benchmark cost of debt allowance.[8]

WELL supports the use of a 10 year tenor for determining cost of debt because this is consistent with the practice of infrastructure business and utilities that have similar risk profiles (Table 5 of CEG report) to the electricity distribution businesses.[9] However, WELL notes that it is also critical that the Commission make an allowance for swap transaction costs to the extent Commission chooses not to adopt a trailing average methodology. The current approach requires WELL to undertake hedging transactions for a future start date, which incurs additional costs (forward start spread), for which there is no compensation provided in the current cost of debt allowance.

In respect of data sources, WELL considers that type of debt issued should reflect the actual practices of businesses. For example, regulated energy businesses commonly issue debt in foreign currencies such as the US dollar. There are a number of good strategic reasons for doing this. In particular, having a presence in multiple debt markets, including large debt markets such as the US market, increases the flexibility that a business has to manage its refinancing risks. This includes reducing its exposure to disruptions to domestic markets and risks associated with capacity and tenor available with bank debt providers. To spread refinancing risk over a period of time, New Zealand businesses have to diversify into international and domestic bond markets, due to the relatively short term funding available from banking institutions. In this context WELL supports CEG's conclusion that foreign currency bonds issues by New Zealand corporations and hedged back into NZD should be included in the Commission's analysis of the cost of debt. This approach is further supported by the recent practice of the AER, which has also started placing reliance on the RBA curve that is inclusive of foreign currency denominated bonds issued by Australian corporations.[10]

WELL considers that a cost of debt estimate calculated using secondary data sources rather than data from primary market where businesses actually issue debt, delivers an overly conservative estimate of the cost of debt and the Commission should have regard to this when estimating the benchmark allowance.

To better manage the risks associated with a narrow re-pricing window, WELL proposes that the Commission allow businesses to nominate their own averaging period rather than having a fixed averaging period for all businesses. This would also help businesses lower their actual debt management costs.

4. Inflation

Consistent with CEG's advice in its report with the ENA's submission, WELL considers that Commission should amend the IMs relating to revaluation and the roll forward of the RAB to avoid any under compensation or overcompensation due to differences in forecast and actual inflation. The Commission should also consider giving weight to market based approach for determining inflation which will be more consistent with the inflation expectations embedded in the cost of capital parameters.

5. Split WACC

WELL considers that the DPP and CPP WACC should be made equal for the period they apply to, to avoid any scope for opportunistic behaviour in relation to investment decisions. A split WACC would unnecessarily introduce complexity in the financial models used for determining the building block allowances whilst having only marginal impact on allowances.

8 CEG, Key reforms to the rate of return under the IMs, 2016

9 CEG, Key reforms to the rate of return under the IMs, 2016.

10 CEG, Key reforms to the rate of return under the IMs, 2016.

6. Closing

WELL considers the WACC IM to be a critical topic worthy of extensive consideration in the current IM review and one where there are clear alternatives, which are easy to implement and remain consistent with a low cost default regime that applies to multiple businesses. Given the importance of this topic, WELL notes that the response time provided to businesses post publication of the update paper and the Chorus determination was insufficient to undertake a comprehensive review of all the issues discussed by the Commission. WELL expects that the Commission will engage proactively with businesses on the cost of capital issues raised in the current submissions and also on how the actual cost of debt data collected by the Commission will be used for informing the cost of capital IMs.

WELL appreciates the opportunity to contribute to the IM review. Please do not hesitate to contact Megan Willcox, Regulatory Projects Manager, on MWillcox@welectricity.co.nz if you have any queries.

Yours faithfully

Greg Skelton

CHIEF EXECUTIVE OFFICER

Attachments: -

1. CEG, Key reforms to the rate of return under the IMs, 2016.
2. CEG, Use of Black's simple discount rule in regulatory proceedings, 2016.
3. CEG, Inflation – revaluations and revenue indexation, 2016.
4. CEG, Asset Beta, 2016.
5. CEG, Critique of the AER's JGN draft decision on the cost of debt, 2015.
6. SFG, Response to the QCA Discussion Paper on risk free rate and market risk premium, 2013.
7. SFG, Response to the QCA approach to setting the risk free rate, 2013.
8. SFG, Evidence on the required return on equity from independent expert reports, 2013.
9. Incenta, Term of the risk free rate for the cost of equity, 2013.